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**BILL BRATTON, GLOBOCOP | ANOTHER iPAD STORY? OH, YES**

Bloomberg BusinessWeek

# It Wasn't Our Fault. Really.

**In exclusive interviews, the brass at Goldman Sachs come out of their bunker to swear they didn't sell America short. Is anybody buying it?**





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# Bloomberg BusinessWeek In Depth



Goldman's Blankfein has been trying to live down his "doing God's work" quip since November

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Record profits, big bonuses, huge market share—and a reputation as the toxic symbol of all that's wrong with Wall Street. Talking with *Bloomberg BusinessWeek*, Goldman executives make their case for why their firm owes no one an apology.

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# THE WEEK IN BUSINESS

Edited by
Cristina Lindblad



## ECONOMICS & POLICY

### DRILL, BABY, DRILL

Reviving a debate that raged during the 2008 Presidential race, **Barack Obama** on Mar. 31 announced plans to open up areas off the Atlantic and Gulf coasts to oil drilling. The U.S. has put off exploiting fossil fuels in environmentally sensitive areas for decades. Obama's move is unlikely to radically alter the U.S. energy supply picture in the near term. Some 5.4 billion barrels of oil and 37 trillion cubic feet of gas may lie below the newly opened waters, according to estimates by **PFC Energy**, Washington-based consultants. That would add more than 15% to U.S. reserves. But companies will need several years to discover and develop deposits. An expanded offshore drilling program should provide a boost to the U.S. oil industry and eventually lessen the country's dependence on energy imports.

### JUDGMENT IN BEIJING

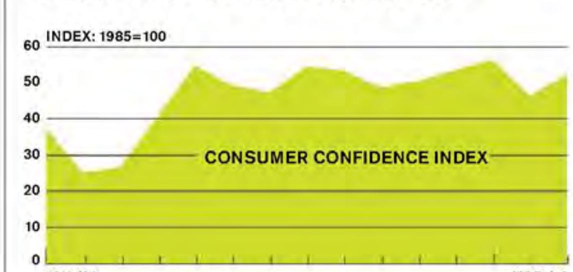
On Mar. 29 a Chinese court sentenced four employees of **Rio Tinto Group** to prison terms of as long as 14 years for taking bribes and trading commercial secrets. In response, the mining giant said it would probe its processes and controls in China. Britain's corruption watchdog is considering launching its own inquiry.

**Obama's plan could add as much as 5.4 billion barrels of oil to U.S. reserves**

### CAUTIOUS OPTIMISM

When it comes to the economy, Americans are breathing a bit easier. Consumer spending rose 0.3% in February, marking the fifth consecutive month of increases, said the **Commerce Dept.** on Mar. 29. A day later,

## THINGS ARE LOOKING UP




Data: The Conference Board

MARIANNA DAY MASSEY/ZUMA PRESS; CHART BY STANFORD KAY/BW




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# EXECUTIVE SUMMARY



Rousseff, Lula's choice to succeed him as Brazil's President, is trailing in polls

**The Conference Board** reported that its Consumer Confidence Index rose to 52.5 in March, almost double what it was a year ago.

## THE DRAMA CONTINUES

Debt-ridden Greece says it won't default, but the euro club isn't taking any chances. In a two-day meeting that began on Mar. 25, the Continent's leaders approved a plan under which the European Union would provide billions of dollars in bilateral loans to Athens, while the International Monetary Fund could offer additional support if needed. The proposed bailout did little to calm investors. On Mar. 29, Greece floated a seven-year, $6.7 billion bond. Two days later its yield had climbed above 6%. Athens needs to refinance $15.6 billion in debt by the end of May.

## LEADERSHIP

### A BRIDGE TO THE PRESIDENCY

**Brazilian President Luiz Inácio Lula da Silva** on Mar. 29 unveiled a $886 billion investment program designed to buttress the country's weak infrastructure—as well as the political fortunes of his preferred successor. The four-year plan calls for a mix of public and private funds to be plowed into new roads, ports, and railways. Its implementation could fall to **Dilma Rousseff**, who on Apr. 1 quit her post as cabinet chief to campaign full-time for the October presidential

## IDEAS FORGET THE INTERNET, IT'S NOW THE SPLINTERNET

The Internet as we knew it has ceased to exist, say a pair of analysts at **Forrester,** the tech research firm. We are now living in the era of the Splinternet.

In a white paper published earlier this year, Josh Bernoff and Shar VanBoskirk argue that the golden age of the Web, where people accessed sites using standard or similarly formatted PCs and browsers, is ending. Witness the rise of proprietary platforms like Apple's iPhone, Amazon's Kindle, and Google's Android—and soon Web-connected TVs with their own interactive formats. Then there are social sites like Facebook, which sequester their content behind a password, far from the roving eyes of search engines.

How do marketers navigate across this fragmented landscape? Not easily, say Bernoff and VanBoskirk. "The standardized Web established links, click-throughs, and analytics, which in turn gave rise to now mainstream interactive marketing tools like online advertising, search marketing ads, and e-mail marketing," they write. Forrester figures that in the U.S. alone, marketers poured $25.6 billion into these technologies last year.



The pair warn that marketers must move with caution through this new world of duelling devices, applications, and standards. Missteps can be costly. Here's why: In the era of the unified Web, if a company chose to advertise on a poorly performing site it could move its ads to another site. But what if said company shelled out to build an application for Facebook and then found its customers had deserted that site for LinkedIn? Then there may be no choice but to start from scratch.

▸ **The Splinternet**

(TOP) NELSON ALMEIDA/AFP/GETTY IMAGES; (BOTTOM) BRIAN STAUFFER




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# EXECUTIVE SUMMARY

elections. The candidate for the leftist Workers' Party has seen her early lead in the polls erode in recent months and is now in second place.

## FINANCE

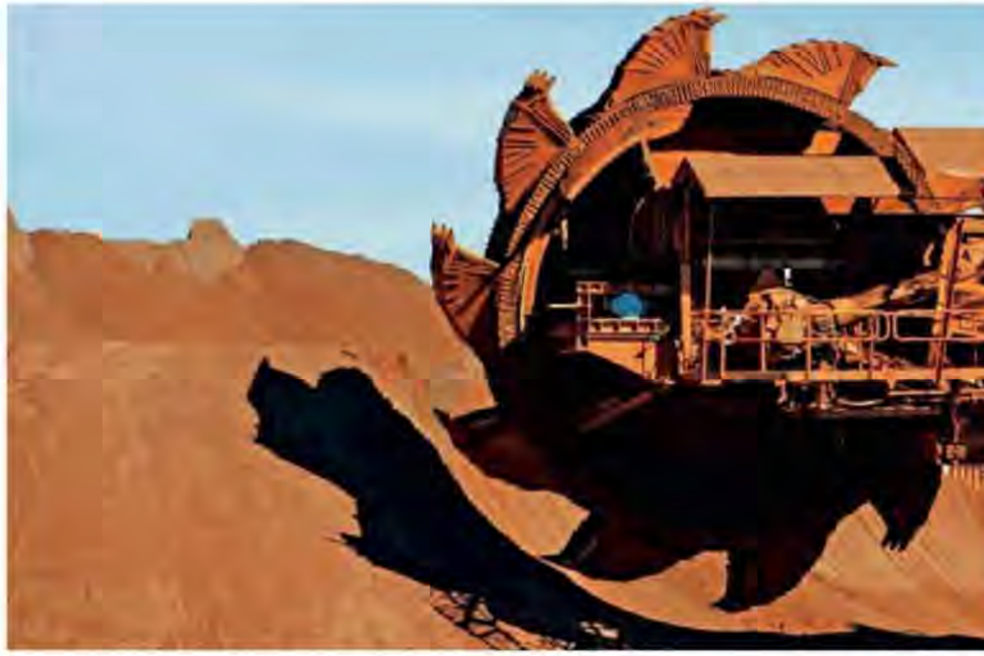
### GETTING OUT OF CITI

The U.S. **Treasury Dept.** on Mar. 29 outlined a plan to gradually sell down the government's 27% stake in **Citigroup** over the course of the year. The agency's 7.7 billion common shares in Citi, which got $45 billion from Uncle Sam, have a market value of $31 billion based on the stock's Mar. 31 closing price. The staggered sales could net a profit of $8.2 billion for the Treasury, bringing the Obama Administration closer to its goal of recouping the money spent rescuing banks.

## STRATEGY

### NEW PRICING POWER

Iron-ore producers stand to scoop up big profits as they move away from a 40-year-old system under which prices were set through annual contracts. On Mar. 31, **Vale** and **BHP Billiton** inked quarterly deals with Asian mills. The World Steel Assn., a Brussels-based group, reacted by issuing a call to national competition watchdogs to investigate whether leading producers are abusing their market power.



BHP Billiton in Australia. The company could profit from new short-term contracts

TIM WIMBOURNE/REUTERS/CORBIS

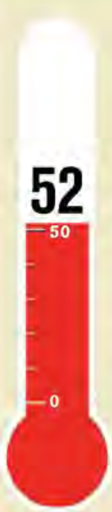
### GENE DOMINANCE

In a Mar. 29 decision, a federal judge in New York invalidated patents on genes owned by **Myriad Genetics**, which markets a diagnostic test that tells women whether they are at higher risk of developing breast cancer. Biotechnology and gene-testing companies are split over whether the ruling will deter or spur innovation, but most expect the issue to move to higher courts. In the meantime, the U.S. Patent & Trademark Office is expected to carry on issuing gene-related patents.

## TECHNOLOGY

### UNLOCKING THE iPHONE

Shares of **Apple** and **Verizon Communications,** majority owner of **Verizon Wireless,** jumped on a Mar. 29 story in *The Wall Street Journal* saying the consumer electronics giant is working on a version of its popular iPhone that will run on Verizon Wireless' network. **AT&T Wireless** has had a U.S. monopoly on the iPhone since 2007. The move to add other carriers may be designed to blunt competition from handsets built on **Google**'s Android software. Yet there were no signs of a rivalry on Mar. 26 when Apple CEO **Steve Jobs** and Google CEO **Eric Schmidt** were sighted chatting amicably at a Palo Alto café.




**THE OPTIMISM METER**

### WHAT A DIFFERENCE A YEAR MAKES

The Meter dropped to 52 on Mar. 30, down from 54 a week earlier. The current reading is nearly double the level logged one year ago, as U.S. stocks were just beginning to rally. Since then the share of Americans who believe the economy is getting better has improved by 77%. Developed by ***Bloomberg BusinessWeek*** using data from pollster **YouGov,** the Meter is a proprietary measure of sentiment and expectations, economic statistics, and market forecasts. It evaluates shifts in outlook among individuals, professional investors, and economists in the areas of U.S. economic growth, jobs, equity markets, and real estate.

Calculated using consumer polling, economic forecasts, and financial markets data; 0=lowest and 100=highest Data: YouGov, *Bloomberg BusinessWeek*

**10%**

Unemployment rate in the euro zone in February, the highest since the single currency was introduced a decade ago

Data: Eurostat

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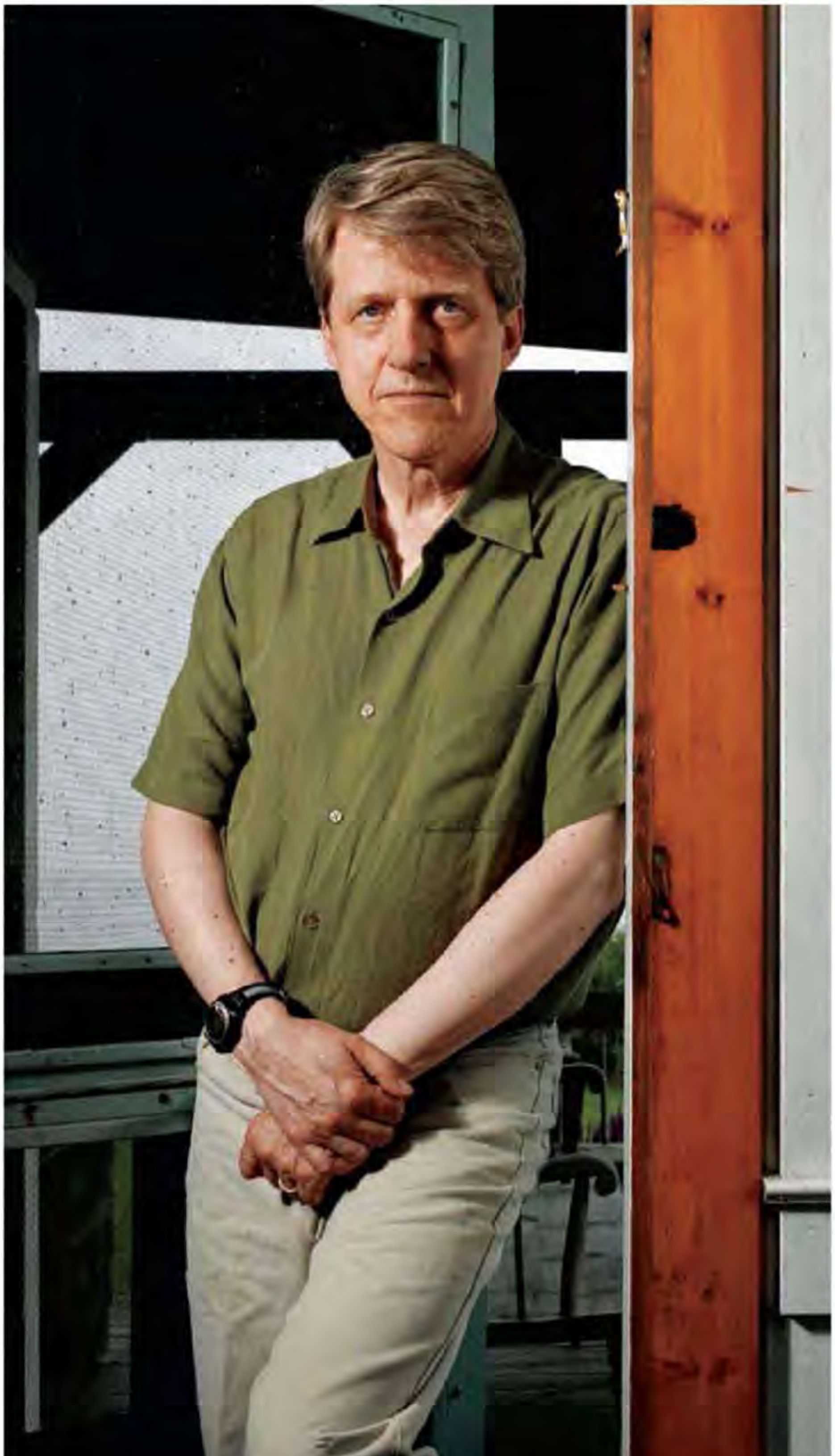



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MAKING SENSE OF INVESTING

# AT THE TABLE CHARLIE ROSE





(TOP) BRAD TRENT; (BOTTOM) MICHAEL LEWIS/CORBIS OUTLINE

## ECONOMIST ROBERT SHILLER Is a Double Dip in Housing Ahead?

The Case-Shiller Home Price Index, a respected measure of housing prices across the country, shows a slight improvement for the month of January. However, housing starts are sluggish, delinquencies are up, the foreclosure level remains troubling, and the National Association of Realtors just reported a drop in sales of existing homes. On Mar. 31, the day after the most recent Case-Shiller numbers were released, I talked with Bob Shiller, the Arthur Okun Professor of Economics at Yale and co-creator of the index.

CHARLIE ROSE
**The S&P Case-Shiller Index for January saw upticks in 12 major metropolitan markets. Is that an encouraging sign for the housing market?**

ROBERT SHILLER
The fact that [prices] are up on a seasonally adjusted basis, although the market has been weakening, is definitely encouraging.

**You said on Bloomberg Television yesterday that there is a 50-50 chance of a double dip in housing.**
I am really going out on a limb to say it's as high as 50-50. Double dips are rare. You know, I have a forecasting model that I used to use years ago when we were doing forecasts for *The Wall Street Journal* in the late 1990s, and that model emphasized momentum before anything else. When prices go up, they tend to go up for years. That's history. Whereas if they start going down, they'll go down for years. We



Myra and David Sandlin check out a distressed home for sale in Miami on Mar. 29

JOE RAEDLE/GETTY IMAGES

saw home prices decline between 2006 and 2009—three years of decline. And now that [the market is trending] up, you know, it's perfectly plausible to think we'll have three years or more of increases. But I'm not so sure. We don't know how much of this is transitory because of the government support. We're in such an unusual economy now that [a double dip] has substantial probability.

**You've said that 90% of the housing market is supported by the government.**
Well, it's 80% or 90%. Really almost the whole market now is government. And we know this can't last.

**And that means prices are being artificially inflated?**
It seems to. Government support is especially prominent in sales of existing homes, which shot up to over 6 million on an annual rate in November 2009, the month that the home buyer tax credit initially was supposed to expire.

**Do we need another stimulus?**
I think we may. Our latest GDP growth number was phenomenal. Things seem to be coming back. But I'm worried about a double dip. And I worry that the political support for another stimulus may not be there.

**Where do confidence levels fit in?**
Confidence has many dimensions. The things measured by the Conference Board and by the Michigan consumer-sentiment people are one aspect of confidence. That has shown improvement since a year ago, but it's still at a low level. I've been trying to develop other confidence indexes in terms of stock market confidence, home buyer confidence. But I don't know that I have the answer. One thing George Akerlof and I talk about in our book, *Animal Spirits*, is that the economy is driven by stories. And there's a story at any point in time that colors people's thinking. Right now the story is one of anger, frustration, and disillusionment—mistrust. The Tea Party movement is one result of that. And that is potentially holding back the economy.

**Do you like the Dodd financial-reform bill?**
I think it's the first step. I wish it were stronger. For example, his initial plan to consolidate regulatory authorities would have been important because part of the problem that led to this crisis was that the regulatory authorities were too scattered. But he backed off on that.

**He was going to take authority away from the Fed, too, and he got a lot of protests.**
Right. I think the Fed should have a lot of regulatory power. The central banking tradition is really one of understanding market psychology. It's part of what central bankers do ... so that's the organization that should be in charge of systemic risk management.

**How should derivatives be handled?**
I think they should be put on exchanges. What I've been writing about in my books is that we need to expand derivatives. I'm giving a talk tomorrow at the SEC and again on Friday at the Federal Reserve about a proposal to create GDP-linked bonds. It would be a new derivative because the government would be issuing bonds linked to the GDP. My argument is that this time of crisis is the time to start doing that. I think it would create a better and more robust market for our debt around the world right when we have to worry about our debt. Derivatives represent an important technology. We have to get it right. Moving them to exchanges is one way of getting it right. |BW|

**WE'RE IN SUCH AN UNUSUAL ECONOMY NOW THAT [A DOUBLE DIP] HAS SUBSTANTIAL PROBABILITY**

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**BUSINESS OUTLOOK | RICH MILLER AND COTTEN TIMBERLAKE**

# AS RECESSION FADES, AMERICANS HEAD TO THE MALL

**After two long years of belt-tightening, U.S. consumers are finally starting to spend again. That is giving the economy a much needed boost. Will the shopping spree continue?**

It has long been a truism among economic forecasters: Never underestimate the willingness of Americans to spend. Year in and year out, in good times and bad, consumer spending somehow always managed to keep rising. Until the Great Recession hit, that is. Spending fell in real, inflation-adjusted terms in 2008 for the first time in 28 years, dropping by 0.2%. Outlays then declined a further 0.6% in 2009, the first back-to-back slump since the 1930s.

It took a series of aggressive government moves—from middle-class tax cuts to the cash-for-clunkers automobile trade-in plan—to get Americans shopping again. The result: Consumer spending rose in February for the fifth straight month, jumping by 3.4% from a year earlier. The key question facing the economy for the rest of this year is whether these gains will continue.

**$5.7 trillion**

**Increase in U.S. household net worth in 2009**

Data: Federal Reserve

A growing number of economists and retailers think they will. Department store Saks is "moving from defense to offense," selectively rebuilding inventory and increasing investment as consumers "come out of their shell," says CEO Stephen Sadove.

Behind the budding optimism: pent-up consumer demand, higher incomes and wealth, and a more generous supply of credit from banks. Put it all together and it looks like the rise in spending is sustainable, says Michael Niemira, chief economist for the International Council of Shopping Centers in New York.

As evidence of what Niemira calls the "large reservoir" of catch-up demand, automakers sold only 10.4 million vehicles in the U.S. last year. That was down 21% from 2008 and well below the 14 million that President Barack Obama's economic adviser, Lawrence Summers, reckons is needed each year to replace scrapped vehicles and to take into account population growth.

Consumers are better positioned to satisfy their cravings as incomes rise in tandem with the economy. Wages and salaries increased 0.8% in the six months through February after falling 4.9% in the previous 12 months. And if the job market finally picks up—as many economists now expect—that will add to household spending power.

As the stock market surges, with the Standard & Poor's 500-stock index up more than 70% from its March 2009 low, upper-income Americans are re-acquiring the means and confidence to spend again. Household net worth rose 11.8%, to $54.2 trillion, in the fourth quarter of last year from $48.5 trillion in the first quarter of 2009.

The rise in wealth means those who are better off can afford to save a bit less. The household savings rate fell to its lowest level in more than a year in February. But at 3.1%, it was still well above the 1.7% monthly average in 2007, before the recession began.

Banks are also loosening up on credit after seeing their profits rise. A net 9.6% of banks surveyed by the Federal Reserve in January reported an increased willingness to make installment loans to consumers, the first positive reading since 2007.

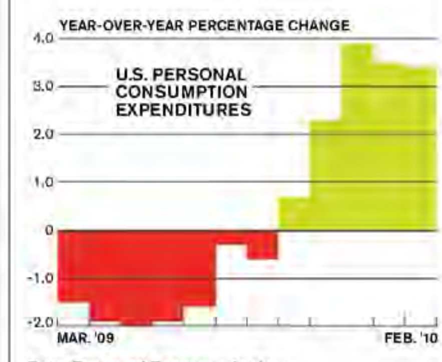
Americans undoubtedly still have way too much debt. Yet they have managed to reduce it—the first time they've done so on a sustained basis in more than 50 years. Household liabilities fell to $14 trillion in the fourth quarter of 2009 from a record $14.5 trillion in the third quarter of 2008.

Some of that drop probably came from financially strapped homeowners losing their properties to foreclosure. Yet whatever the reason, it frees up money to be spent elsewhere. The share of income households must devote to debt payments declined to 12.6% in the fourth quarter, the lowest since 2000.

That's not to say consumers are about to return to their free-spending ways. The deepest recession since the Great Depression has left enough of a scar on the American psyche to keep that from happening.

But conditions seem to be falling into place for what Chris Varvares, president of Macroeconomic Advisers, calls "solid, if unspectacular consumer spending growth this year near 3%." After two dismal years, that's something to be welcomed. |BW|

## A REVIVAL FOR CONSUMER SPENDING




Data: Bureau of Economic Analysis

# A visionary mind and an educator's heart



## Harold W. McGraw, Jr.

Chairman Emeritus, The McGraw-Hill Companies

IN MEMORIAM

*1918–2010*

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22 Central bankers split over interest-rate policy
24 House flippers are back
28 The SEC's eagle eye
29 The World Cup, cracked



# The iPad Isn't Just Fun and Games

## Nope, it's fun and games and spreadsheets and presentation graphics and collaboration tools and ... Meet your newest workplace productivity enhancer

**COMMENTARY**

**By Rich Jaroslovsky**

Apple has largely pitched the iPad as an ideal way to consume media in all its many forms. Books, games, movies, magazines—step right up, folks, we've got it all for you in one magical device!

For the iPad to be truly revolutionary—Steve Jobs' word—it'll have to do a lot more than be a better e-book reader. The real promise of the device is that it has a chance to redefine what we think of as personal computing. And that has implications not just for Apple's own Macintosh business but for Microsoft's, Google's, and just about everyone else's.

For business users and others looking for a new productivity tool, the pound-and-a-half iPad offers a marriage of the always-connected ultra-portability of a wireless phone with the power and flexibility of a laptop or even a desktop PC. "I think this is the new Mac, I really do," says Marc Benioff, chairman and chief executive officer of salesforce.com. "People aren't going to want Macs anymore. I think people won't want laptops anymore once they see what's really possible on great tablets."

It's safe to say no one at Apple, least of all Jobs, is eager to see the demise of its $999-and-up line of Mac laptops and desktops. (Apple declined to comment for this story.) But there are plenty of potential business customers who seem as ready to shift platforms as Benioff. More than half the people surveyed recently by Zogby International said they would use a tablet device such as the iPad for working outside the office, according to software maker Sybase, which commissioned the poll. "Clearly, the iPad has a role to play in the business market," says Charlie Wolf, a Needham & Co. analyst who has a buy rating on Apple. "The demand appears to be far more diverse than I originally expected."

At $499 for the base model with Wi-Fi and Bluetooth, the iPad is in the same price ballpark as netbooks, the underpowered miniature laptops that run Microsoft Windows. True, the iPad has much less local storage—from 16 to 64 gigabytes of solid-state memory depending on the model, vs. the 160-gigabyte hard drive found on your typical netbook. What the iPad lacks in storage it tries to make up for with connectivity, which, for mobile business users, suggests the need for 3G service. That adds $130 to the cost of the unit, plus $15 or $30 a month for the data plans being offered by AT&T.

### iPHONE VS. ANDROID II?

Microsoft and the makers of Windows PCs aren't the only ones who have to wonder what the iPad may mean for their market. Google, too, has to figure out the potential impact on its Chrome operating system. Netbook-like devices using Chrome to connect to Google software and services over the Internet should start appearing in significant numbers this year, and comparisons will be inevitable. We may be in for a repeat of the iPhone vs. Android struggle that's playing out in the wireless-phone market right now, with Apple pitting its polish and vast selection of third-party apps against Google's willingness to give its software away free to all comers. ("A healthy competitive ecosystem is good for the industry," says Google spokeswoman Carolyn Penner.)

While the iPad runs most of the 150,000 applications already avail-

PHOTO ILLUSTRATION BY ARTHUR HOCHSTEIN (PHOTO BY ANDERSEN ROSS/GETTY IMAGES)



# iPAD APPS GO TO WORK

Developers will create 5,000 to 10,000 productivity apps for the iPad by yearend, estimates Gartner analyst Ken Dulaney. A sampling of the wares expected to be ready to go on Launch Day, Apr. 3:

## iWORK

Company: Apple
Price: $29.97
Apple's trio of tools for workers, $9.99 apiece: Pages word processor; Keynote presentation creator; Numbers spreadsheet.

## EVERNOTE

Company: Evernote
Price: Free; $5/mo. or $45/yr. for ad-free, premium version.
Virtual file cabinet for anything you want to keep handy—memos, voice recordings, to-do lists, articles.

## EMPOWER CRM

Company: iEnterprises
Price: $40/mo
Tool for salespeople to manage new business leads.

## BOX FOR iPAD

Company: Box.net
Price: Free for customers of Box.net service, which costs up to $15/month.
Store up to 15 GB of files online.

## CITRIX RECEIVER

Company: Citrix
Price: Free for use with XenApp and XenDesktop, $95 to $600 per user.
Remotely access another computer, even if it's a PC.

## TWITTERRIFIC

Company: Iconfactory
Price: Free; $4.99 for ad-free version.
See what potential customers are chattering about on Twitter.

## WHAT THE ANALYSTS THINK

Sales estimates for the iPad vary widely. It'll be big, says Morgan Stanley's Katy Huberty, "but it's a new market." Apple was trading around 235 at press time.

| ANALYST | FIRM | IPAD 2010 UNIT SALES ESTIMATE | APPLE SHARE PRICE TARGET |
|---|---|---|---|
| David Bailey | Goldman Sachs Group | 6 million | $240 |
| Katy Huberty | Morgan Stanley | 6 million | $250 |
| Andy Hargreaves | Pacific Crest Securities | 5.3 million | $300 |
| Ben Reitzes | Barclays Capital | 5 million | $285 |
| Gene Munster | Piper Jaffray | 2.7 million | $284 |
| Shaw Wu | Kaufman Bros. | 2-2.5 million | $253 |

Data: Analysts' reports

able for the iPhone and iPod Touch, its larger, longer-term business potential is visible in three sort-of-new apps that Apple is premiering along with it. These are rewritten versions of the Mac's iWork office software suite: Pages, a word processor; Numbers, a spreadsheet; and Keynote presentation software. The Mac version of iWork sells for $79, or $49 with a new machine; you'll be able to buy each app separately for $9.99 on the iPad.

### PRICEY REMEDIES

The three have been reengineered to take advantage of the iPad's touchscreen interface, though that may not be the way many businesspeople choose to use them. Onscreen typing in Pages, for instance, can be problematic because the shape and materials of the iPad's case make it prone to sliding around on a smooth surface. It's a lot easier to use the iPad when it's on your knees than when it's on a tabletop.

There will be remedies for such issues, but they'll add to the price. At the iPad launch event, Jobs showed off a new combination keyboard/docking station that holds the iPad at a good angle for typing. That's an additional $69, and it isn't shipping for another month. Bluetooth keyboards will work with the iPad, too; the question is whether people who spent up to $829 on a piece of sleek, modernist design will want to lug them around.

On the Mac, iWork competes with Microsoft Office. On the iPad, it at least initially faces little direct competition. Microsoft for its part hasn't announced plans to create a version of Office for the iPad. "It's something we're looking at," says Kristen Woody, a spokeswoman for Microsoft. Still, there will be ways for salarymen and -women to get their Excel spreadsheets and Word documents. Citrix Systems said that on Apr. 3—iPad Launch Day—it would unveil a version of its virtualization software that lets owners remotely access the same screen they see on their office PC. "I think this device will be the ultimate business tool" for CEOs, salesmen, and other mobile workers, says Citrix CEO Mark B. Templeton. He expects use of Citrix's app to exceed the 400,000 downloads of a version for the iPhone that was announced last May. "This will have a bigger impact on our business than the iPhone," says Templeton.

More business-oriented software is on the way. IBM plans to unveil iPad-compatible versions of its Lotus applications as well as various software collaboration tools (think Facebook for the Dilbert crowd). Offerings from small fry such as LogMeIn should also be available for those who need to create graphs or tap into files at the office. Needham's Wolf says health-care professionals will probably be among the biggest iPad purchasers.

The device's eventual impact as a business workhorse may hinge on whether it turns out to be more of an "in addition to" rather than an "in lieu of" proposition—the gadget you grab for a quick check of e-mail or a glance at the Web, while reserving the netbook, or MacBook for that matter, for more demanding uses. "It's not clear to me that it will be anyone's primary device," says Alistair Rennie, general manager for IBM's Lotus unit. "I think it's going to be an 'and' device, not an 'or' device." While he doesn't see the iPad replacing his iPhone, BlackBerry, or laptop, he thinks its role will expand from the personal to business. "Expecting the things you use at home on the weekend to work in the office is now an unstoppable trend," he says.

However many working stiffs find themselves using iPads for their jobs, in the days and weeks after launch, books and movies and games will determine how much of a splash the iPad makes. Book publishers see Apple as a way to reclaim the pricing power they've lost to Amazon.com—at least until their fear of Apple catches up to the level of, say, their iTunes-loathing music industry brethren. Newspapers and magazines are being given an opportunity to reinvigorate their dying business models.

It's worth remembering that it took a while for Apple's most recent game-changing devices to find their niches. The iPod, launched in 2001, didn't graduate from a nice music player to a cultural phenomenon until the arrival of the iTunes Music Store in 2003. The iPhone was an immediate hit when it went on sale in 2007, but its full potential wasn't unlocked until the following year, when Apple allowed developers to write apps that would run natively under its operating system.

Maybe the iPad really will just turn out to be a cool way to read *The Girl with the Dragon Tattoo*, watch *The Hurt Locker*, and play games like Need for Speed. There's a fair chance it will turn out to be much, much more. |BW|

*—With reporting by Peter Burrows, Olga Kharif, Rochelle Garner, Douglas MacMillan, and Connie Guglielmo*




# On one side is Euromoney, on the other the Financial Times, and on top of the podium is Vale.

Euromoney, one of the most important and influential publications in the world, has just elected Vale the Best Managed Company in Brazil and the company with the Most Transparent Accounts in Latin America, for the fourth consecutive time. It has also named Vale the Best Managed Company in the Metals & Mining Sector in Latin America. At the same time, the Financial Times has honored Vale with the FT ArcelorMittal Boldness in Business in the Emerging Markets Award. Vale would like to share these accolades with all who have helped in bringing us to this point, recognizing that we still have far to go.

- Euromoney's annual poll of Best Managed Companies in Latin America 2010
  Best Managed Company in the Metals & Mining Sector in Latin America
  Most Transparent Accounts in Latin America
  Best Managed Company in Brazil
- FT ArcelorMittal 2010 Awards - Emerging Markets Category

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# Inflation Hawks Show Their Talons

**With emotions running high, an intellectual rumble breaks out over the Fed's inflation target**

By Peter Coy

Picture the horror-movie scene in which the terrified family barricades the door to keep the murderer out, only to discover he's already inside. Federal Reserve Governor Kevin M. Warsh evoked that scary image in a speech on Mar. 26 to describe the threat to inflation-fighting central bankers from economists who are, in his view, insufficiently hawkish on inflation. Said Warsh: "Not all of the threats to central bank independence come from outside the walls of the Federal Reserve. Some pressures, however well-intentioned, like in the clichéd scary movie, may come from inside the house."

Emotions must be running high when bland central bankers start casting disagreements over interest-rate policy in terms that are more familiar to fans of Freddy Krueger. The charged language may be further evidence of a growing divide between hawks and doves over how strenuously the Federal Reserve should fight inflation. This isn't a drawing-room debate. The outlook for growth and inflation depends on how quickly the Fed rolls back the emergency monetary easing it put in place to combat the worst economic downturn since the Great Depression.

Until now, the rate-setting Federal Open Market Committee has been remarkably unified under Chairman Ben Bernanke. Even the committee's inflation-phobic hawks have mostly gone along with lowering the federal funds target rate to a basement-floor zero to 0.25% and flooding the banking system with excess reserves to encourage lending.

But the hawks' grumbling is getting louder. Thomas M. Hoenig, president of the Federal Reserve Bank of Kansas City, broke ranks at meetings in January and March, dissenting from the FOMC's determination to keep the federal funds rate at "exceptionally low levels" for "an extended period." Hoenig loses his FOMC vote next year, but two other hawkish regional bank presidents are scheduled to become voting members of the FOMC: Richard W. Fisher of Dallas and Charles I. Plosser of Philadelphia.



Monetary hawks argue that over the long run, very low and predictable inflation is the best condition for growth. In his Mar. 26 speech, Warsh attacked an idea that particularly frightens the hawks: a proposal that central banks should try to make inflation rise a bit to a long-term average of around 4%. (Inflation in personal consumption expenses, excluding food and energy, is all of 1.3% over the past year.) The 4% idea was raised on Feb. 12 in a widely noted paper by Olivier Blanchard, research director of the International Monetary Fund. Blanchard suggested that higher average inflation would make it easier for central banks to stimulate growth in a recession by cutting interest rates. The idea is that cutting borrowing costs to below the inflation rate encourages expansion by effectively paying people to take out loans. Thus, cutting interest rates to zero can be more stimulative when inflation is 4% than when it's just 2%. That's a dangerous idea, Warsh said. "Central banks that desire just a little more inflation may well end up with a lot more."

Here's where the horror-movie plot thickens. Blanchard, as a pillar of the economics Establishment, may well have been the threat "from inside the house" to whom Warsh was referring.

Then again, Warsh may have meant a true Fed insider, John C. Williams, research director of the San Francisco Fed, who wrote a paper similar to Blanchard's last September. But Williams isn't quite the foe hawks might imagine. In an interview on Mar. 29, he said he understands Warsh's misgivings. He added that while there are theoretical advantages to a 4% inflation target, the risks of confusing the market by moving to a higher target now might be unacceptably great.

Confused yet? Don't worry. The main plot line is still hawks vs. doves. And as the U.S. economy recovers haltingly, that fight isn't going away. |BW|

ILLUSTRATION BY MATT KENYON

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# Flipper, Come Home. All Is Forgiven

**That symbol of real estate fever—the buyer who fixes and sells homes—is back. This time he's good for us**



**By Prashant Gopal**

On an unusually hot March afternoon, the steps of the Maricopa County courthouse in downtown Phoenix fill with people in sunglasses, shorts, and flip-flops whispering urgently into cell phones. They are "flippers," here for the daily outdoor auction of foreclosed homes—bidding for themselves or clients who plan to buy houses cheaply and fix them up for a quick sale. And with the economy starting to percolate and real estate markets bottoming out, the auctions are drawing bigger crowds. "A year ago, bums outnumbered bidders at the courthouse steps," says Sergio Rodriguez, who bought and sold 48 properties last year even as falling home values scared other investors away. "Now the bums are way outnumbered."

Improbable as it sounds, house flipping—that hallmark of American real estate mania—is making a comeback. All around the country, but especially in some of the regions hit hardest by the housing slump, investors are swooping in on distressed properties and banging them into shape for sale to first-time home buyers, vacation-home seekers, and people looking for rental income. In Phoenix last year, the number of foreclosed homes that changed hands within six months of being purchased—the best statistical measure of flipping activity—increased 81% from the previous year, to 4,661, according to RealtyTrac, which compiles foreclosure data. Las Vegas flips rose 38%, to 8,042, in 2009; in Riverside and San Bernardino counties in California, they climbed 45%, to 17,203; in the Cape Coral (Fla.) area, flips almost tripled.

This may look like another case of "here we go again" (like Wall Street pay), but flipping 2.0 has some important differences from the previous version. In fact, flipping may now serve a constructive purpose, helping to clear out backlogs of foreclosed homes and stabilize distressed neighborhoods. "We're the good guys because the government doesn't have enough money to fix these homes up," says 42-year-old Phoenix investor Harry D'Elia.

Indeed, the government has given its seal of approval to house flipping, an activity it used to discourage. At the Federal Housing Administration, a one-year waiver of anti-flipping rules took effect Feb. 1, so borrowers can now get FHA financing to acquire homes from investors who have held title for less than 90 days. "We do believe investors will play an important role in today's marketplace because they tend to be more liquid than first-time homebuyers," says Vicki Bott, a deputy assistant secretary at the Housing & Urban Development Dept. in Washington.

As prices soared from 2000 to 2005, buying and selling homes for quick profits was such an obsession that it inspired cable television series including *Flip This House* on A&E and *Flip That House* on TLC. "Everybody made money on the way up," says Richard C. Davis, who helped create *Flip This House* and appeared in its first season.

**"EVERYBODY MADE MONEY ON THE WAY UP," SAYS RICHARD DAVIS. THEN THE MARKET TURNED. NOW "AMATEUR HOUR IS OVER."**

When prices began to fall and credit tightened, speculators who bought at the top were stuck with houses they couldn't unload. Many lost homes to foreclosure; others are renting out their flips as they wait for values to rise. "Amateur hour is over," says Davis.

Some professionals who had the capital or nerve to ride out the lean years are still in the game. Rodriguez and his business partner, Brian Bogenn, have been flipping houses for more than six years. They survived by switching tactics. During the boom they bought most of their houses on the open market and could take their time with renovations. Now they buy cheap houses in foreclo-



DAVE LAURIDSEN

sure and patch them up quickly. "One of the reasons we're still doing it is that we keep changing as the market changes," says Bogenn.

Davis, CEO of Trademark Properties in Charleston, S.C., says he has flipped 25 homes since returning to the business in October. And yes, he's filming a new series about empty multimillion-dollar homes that he buys, repairs, and peddles for half what they might have fetched in the boom.

The business is also attracting newcomers like Brandon Hunt, a 28-year-old Indiana native who used $600,000 in cash supplied by his father-in-law to buy four foreclosed Phoenix-area houses in the summer of 2008—just before the boom went bust. Hunt had a few nervous moments as the stock market plunged in the fall of 2008 and considered renting out the homes if he couldn't sell them. "I was like, 'Did I just get into having my father-in-law's money tied up in four rental properties?' " He staged the homes with tasteful art and furniture, including kitchen tables where he envisioned buyers signing contracts, and his patience paid off. By the end of the year he managed to sell all four for a small profit, two to first-time home buyers, one to a woman going through a divorce, and the fourth to a couple who were downsizing.

Hunt aims to fix up his houses and put them back on the market in two weeks

Despite the scare, Hunt was hooked. Backed by more cash from his father-in-law, he turned over 46 properties last year, netting about $1 million. He's found that some bargain hunters, rather than face the hassles of buying a foreclosure directly, are willing to pay extra for new granite countertops, stainless steel appliances, and a fresh coat of paint.

Patricia and Eric Mattingly, both 43, are typical Hunt customers. In late January they closed on a $355,000 two-bedroom ranch with a pool and

guest house across from a golf course in the Del Norte Place historic district in Central Phoenix. Hunt, who paid $209,000 for the house at auction in September and spent six weeks renovating it, earned $50,000 on the deal. The Mattinglys didn't even know they were buying a foreclosure. "A lot of the other houses we were looking at in the historic district were very old and needed a lot of renovations," says Patricia Mattingly. "We walked in and we said, 'Oh my god, this is move-in ready.' "

In Hunt's hands, flipping is a high-speed, high-tech process. The morning after buying a house, he visits with a locksmith to secure it. He decides how many fans, light fixtures, and cans of paint, and what flooring supplies he'll need and plugs the info into a spreadsheet on his BlackBerry. He then e-mails the order to the local Lowe's home improvement store with an address and delivery date. The contractor arrives at the house the same day the supplies are delivered. The houses are typically ready to be listed two weeks later.

Flippers are finding they can sell



## WILL FLIPPING AGAIN BECOME A NATIONAL PASTIME? SOME SAY THE OPPORTUNITIES ARE ALREADY SHRINKING



(L TO R) JOSHUA LOTT/BLOOMBERG; DAVE LAURIDSEN






Bidders at a Phoenix foreclosure auction; a recent Hunt purchase

to foreign buyers who see value in the battered U.S. market. Real estate agent Brad Cozza, who has flipped foreclosed homes in the Cape Coral (Fla.) area to Israeli, German, and Spanish investors, says he got a lot of serious inquiries after making a presentation to 925 Israelis at a conference last month in Tel Aviv. The conference was organized by America Israel Investments, which buys foreclosed homes in Lee County, Fla., through auctions, short sales (in which the lender accepts less than is owed on the mortgage), and directly from banks. Edmon Mamane, the company's owner, said he pays $48,000 to $60,000 for homes, some of which were never lived in, and sells them to Israelis for about $80,000.

Dror Shlomi bought a 2,200-square-foot two-family house from America Israel Investments a few weeks ago for $79,000 in cash. The two families occupying the four-year-old property pay him a combined $1,300 a month in rent, which more than covers the $300 a month he lays out for management fees, taxes, and insurance. Shlomi says he is in the process of selling his 10 investment properties in Israel and shifting his focus to Florida. "Last year, prices in Israel went up and in the States they went down," he says. "So we decided this is the right timing to try to find interesting things in the U.S."

Will flipping once again become a national pastime? Some professionals say the opportunities are already shrinking. "If someone is thinking about quitting their day job [to flip houses], they should think twice," says Robert Fahn, 50, who along with a partner has bought and sold 10 homes in the Sacramento area since last February. With all the newcomers bidding up prices, he says, margins are getting squeezed and "at some point the market is going to go away." Even so, Fahn, who is scouting opportunities in Florida and Phoenix, says he is in it for the long haul. "This is not a get-rich-quick business," he says. "This is a grind-it-out business." |BW|




# Can the SEC Get Its Street Cred Back?

**Elaine Greenberg is investigating abuses in the muni bond market, as the commission tries to rebuild trust**



Greenberg: "There's some very egregious conduct"

LAUREN FLEISHMAN

**By Martin Z. Braun**

The Securities & Exchange Commission was criticized by lawmakers for failing to uncover Bernard Madoff's $65 billion Ponzi scheme and other investigatory lapses. So a crackdown on abuses in the $2.8 trillion U.S. municipal bond market would be a welcome development right about now at the SEC.

Chairman Mary Schapiro is counting on an associate director in the agency's Philadelphia office to deliver the goods. That would be Elaine Greenberg, a 20-year SEC veteran who is leading one of the most ambitious municipal bond market investigations since the 1990s. Now she's looking into whether banks, such as JPMorgan Chase and Bank of America, colluded with brokers to artificially lower the promised return of proceeds raised in municipal debt offerings. She's also looking at public officials who hire political contributors as investment advisers—and local governments that fail to disclose their true financial condition. "There's some very egregious conduct that goes on," says Greenberg, whose late-'90s probe into improper Treasury-bond price markups in the muni market led to 21 firms paying $170 million in penalties.

Greenberg, 49, was tapped in January to head the SEC's municipal securities and public pensions unit, one of five task forces created after the global credit crisis. The 2008 collapse of the $330 billion auction-rate securities market left governments and investors with debt they couldn't trade. States and cities are now dealing with more than $1 trillion in budget and pension deficits.

Municipal securities enforcement "was terribly neglected in recent years," says Arthur Levitt, SEC chairman from 1993 to 2001. "Fraud in the municipal market and incompetence, which in some ways is worse than fraud, has never been greater," he said. (Levitt is a director of Bloomberg LP, parent of Bloomberg News.) Some 70% of the debt in the municipal market is held by individual investors.

A graduate of Temple University and its law school, Greenberg is looking into possible price collusion by brokers that allowed banks to pay municipalities artificially low interest rates on the cash they raised from bond sales.

The commission has informed companies including JPMorgan Chase, Bank of America, UBS, Wachovia, and General Electric Capital's Trinity Funding Co. unit (all of which declined to comment) that it determined sufficient wrongdoing occurred to warrant civil charges.

The SEC has also stepped up enforcement of a rule barring securities-firm executives from making political donations to win municipal business. It said on Mar. 18 that the so-called pay-to-play ban applies to corporate officers after it found an unidentified JPMorgan Chase vice-chairman had raised funds for former California Treasurer Phil Angelides in 2002, less than two years before the bank's securities unit underwrote $15.8 billion of state bonds. JPMorgan Chase consented to the inquiry's conclusions without admitting or denying wrongdoing, the SEC said.

In November, two former JPMorgan Securities managing directors were sued by the SEC for alleged pay-to-play deals that allowed the New York-based bank to get $5 billion of bond and interest-rate swap business from Jefferson County, Ala. The transactions nearly bankrupted the state's most populous county. The bankers have asked the judge to dismiss the case.

Greenberg says the municipal market deserves regulatory scrutiny since federal law exempts state and local issuers from the disclosure required of companies, putting public-bond holders at a disadvantage. "When a municipality or a state or any local issuer goes out and seeks to raise money, it's critical they adequately disclose their liabilities," Greenberg says. | BW |

# Not Exactly Marching to Pretoria

**The World Cup was supposed to help revive South Africa's economy, but the fans just aren't lining up**

By Mike Cohen

South Africa has spent $4.6 billion to host the soccer World Cup, including building and refurbishing 10 world-class stadiums. All it needs now is fans—lots of them.

The government had expected the world's most-watched sporting event to attract 450,000 international spectators, helping to create jobs for the one in four South Africans now out of work. But as the June 11 kickoff date nears, officials have had to scale back their expectations. The visitor estimate has been cut to 350,000—a number that may still prove overly optimistic, considering only about 100,000 international air tickets had been sold as of early March. Similarly, the tournament's projected contribution to gross domestic product has been halved, to half a percentage point. "When the World Cup was awarded to us in 2004, the economic situation was completely different," Sports Minister Makhenkesi Stofile told reporters in Pretoria on Mar. 19. "We have to revisit those projections and be realistic."



A promotional video of Nelson Mandela holding the World Cup at a stadium outside Johannesburg

JEROME DELAY/AP

**$4.6 billion**

**Amount South Africa has spent readying for the 2010 World Cup**

Data: Finance Ministry

A low turnout would be a blow to the government's efforts to bolster South Africa's economy, which is emerging from its first recession in 17 years. It would also be an embarrassment for President Jacob Zuma and Sepp Blatter, head of the sport's governing body, the International Federation of Football Assn. (FIFA), both of whom gave repeated assurances that holding the event in Africa for the first time would be a success.

The numbers so far don't look good. MATCH Services, a Swiss company that FIFA contracted to supply ticketing and accommodation services, has relinquished booking rights for more than 450,000 room nights. Sales of corporate hospitality packages are 50% below target, with sponsors and partners returning thousands of tickets for premium seats, according to FIFA.

Some fans of the "beautiful game" are balking at the cost of long-haul flights and peak-price accommodations. "The whole trip for a couple of weeks would have ended up setting us back more than three grand each," says David McNally, an accountant from Swindon in southern England who hoped to make the journey with a group of friends. "That's just too much."

Surprisingly, outside of South Africans, Americans have purchased the most World Cup tickets—107,576 at last count—a testament to the sport's growing popularity stateside. To stoke U.S. interest, FIFA pressured Emirates airlines, a World Cup sponsor, to slash the price of its New York-Johannesburg round-trip flights to $2,000, from $3,000.

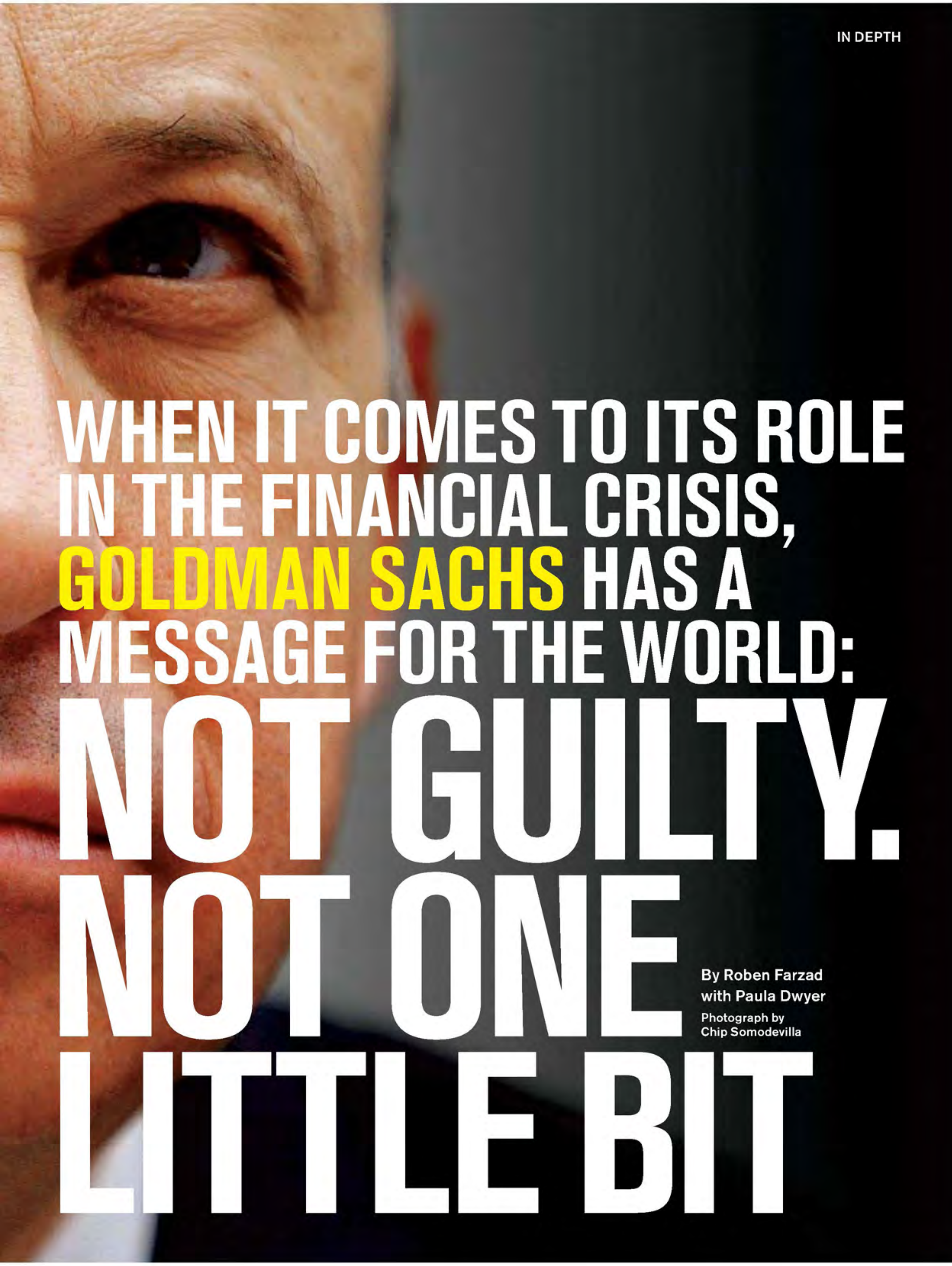
Even under the best of circumstances, South Africa would be hard pressed to replicate the success of the 2006 World Cup in Germany. That event drew about 2 million visitors, earning the tourism industry close to $400 million in revenue and generating $2.7 billion in retail sales, according to government figures. "Any European World Cup has the benefit of having approximately half of the participating teams being within driving distance of the hosts," says MATCH Chairman Jaime Byrom.

While Pretoria is banking on a last-minute rush for tickets as tour operators bring down prices, experts say it would do well to temper expectations. Says Udesh Pillay, co-author of *Development and Dreams: The Urban Legacy of the 2010 Football World Cup*: "The event will not help to significantly mitigate poverty." |BW|

*—With Tariq Panja in London and Franz Wild in Johannesburg*


GETTY IMAGES

Goldman Sachs Chief Executive Blankfein



# WHEN IT COMES TO ITS ROLE IN THE FINANCIAL CRISIS, GOLDMAN SACHS HAS A MESSAGE FOR THE WORLD: NOT GUILTY. NOT ONE LITTLE BIT

By Roben Farzad
with Paula Dwyer

Photograph by
Chip Somodevilla

# PRELUDE TO A PANIC

**September 2008 will live in infamy as the month when the U.S. financial system ground to a halt. But for Goldman Sachs and other institutions, the real panic took place throughout 2007. Here is what happened behind the scenes at Goldman:**

After 10 straight days of mortgage portfolio losses, an internal debate breaks out over whether to short **the mortgage market.** The firm decrees that traders should "get closer to home," meaning neither short nor long, but neutral.

**DECEMBER 2006**

Bear Stearns hedge funds invested in subprime mortgages show signs of distress; both ultimately fail.

**JUNE 2007**






**JULY 2007**

Mortgages underpinning Goldman's securities begin to decline, triggering collateral calls to AIG, which had written $20 billion of credit protection.

**AUGUST 2007**

France's **BNP Paribas** freezes three funds because it's unable to value subprime mortgage assets.

The bankers at Goldman Sachs, by traditional measures, ought to be on top of the world. Eighteen months removed from the depths of the financial crisis, Goldman posted a $13.4 billion profit in 2009, a Wall Street record. When Chief Executive Officer Lloyd Blankfein went on a recruiting trip to Stanford, he was greeted by an overflow crowd. Goldman cast off its Troubled Asset Relief Program yoke and proceeded to pay its employees more than $16 billion. The firm is moving into a new $2.1 billion headquarters on the Hudson River. ¶ Goldman's reputation with its clients—who must have at least $10 million to open an account—has never been better. Among the general public, however, the perception is that Goldman is the toxic epicenter of everything wrong with Wall Street. The firm's 32,000 employees are seen as an army of Gordon Gekkos, greedy manipulators who pumped up the housing bubble, then bet opportunistically on its implosion as American International Group, its trading partner, buckled under massive debts. It is widely alleged—though unproven—that Goldman called on its close friends in government to arrange for an AIG bailout, effectively pocketing billions of taxpayer dollars. "Every game has a sucker," says William K. Black, a professor of law and economics at the University of Missouri at Kansas City who was deputy director of the Federal Savings & Loan Insurance Corp., "and in this case, the sucker was not so much AIG as it was the U.S. government and taxpayer."

Heads Goldman wins, tails you lose, America.

All this public opprobrium has cut into the sublime contentedness that once came with making partner at Goldman Sachs. Executives warn that the firm's position as the whipping boy for a public enraged by financial industry bailouts will crimp future profits. It now has few friends in Washington. Even the market is discounting Goldman, though the company commands the highest return on equity of any major bank—nearly four times JPMorgan Chase's. Today the market values Goldman Sachs shares at just less than half the book multiple at which they sold when Goldman went public 11 years ago. Changes have been made to compensation practices. The firm announced in December that its top 30 executives would, for one year, receive bonuses entirely in long-term stock. More than that, Goldman's leaders say the vilification is unjustified. "This," says Chief Financial Officer David A. Viniar, "has been one of the most frustrating experiences of my 30 years with the firm."

The real story of what Goldman did is so much simpler than the conspiracy theories, says Viniar. Faced with a crisis they didn't foresee, Goldman bankers merely did their jobs, no more and no less. The firm had no subprime agenda, no motives that were at odds with those of their clients. If they were half as smart and devious as the public believes, Gold-

(L TO R) JUSTIN SULLIVAN/GETTY IMAGES; REMY DE LA MAUVINIERE/AP PHOTO; ROGER L. WOLLENBERG/UPI/NEWSCOM; FACUNDO ARRIZABALAGA/NEWSCOM; MARK LENNIHAN/AP PHOTO

As stock market zooms upward, mortgage derivatives market freezes because of subprime default wave. Goldman ups its collateral calls and AIG starts to push back. **Ben Bernanke's Fed** begins to cut interest rates.

## SEPTEMBER 2007




By now, **AIG** has paid Goldman $7.5 billion in collateral but disputes an additional $2.5 billion. Goldman buys insurance on that $2.5 billion with other institutions to cover all its AIG exposure.

## MARCH 2008



## OCTOBER 2007

Stock market hits all-time high. In Britain, subprime lender **Northern Rock** is near collapse. Citigroup begins a string of write-downs on its subprime mortgages. Treasury Secretary Henry Paulson seeks "private sector alliance" on mortgages but initiative fails.

## DECEMBER 2007

Mortgage securities are all but illiquid. Goldman tells AIG it must rely on Goldman's "marks," or valuations for when collateral is due. Other banks' prices are higher but they aren't "actionable," meaning no one would sell the securities at that level.

## FEBRUARY 2008

Goldman informs its auditor, PricewaterhouseCoopers, also AIG's auditor, about the collateral dispute. AIG loses the battle when PwC finds that AIG has understated mortgage derivative losses and says the insurer has a "material weakness" in its accounting.




man would have done far better than it did in 2008.

For the past year, as its name was sullied, Goldman maintained a bunker strategy, largely fending off media inquiries. (The one major exception proved to be a disaster. After Blankfein sat for an interview with the *London Times* in November 2009, he famously quipped, when he thought he was off the record, that he was just a banker "doing God's work.") That fleeting attempt at humor created a weeks-long media storm, after which Goldman stopped trying to defend itself.

Now, Goldman has shifted tactics. On Apr. 7 it will release its 2009 annual report with a letter to shareholders that will, for the first time, explicitly defend its conduct during the mortgage bubble and subsequent collapse. In advance of that, the firm made available to *Bloomberg BusinessWeek* several top officials, including Viniar; Harvey M. Schwartz, who is co-head of the global securities division, which includes the derivatives and mortgage trading desk; and Craig W. Broderick, the firm's top risk manager. Blankfein was not made available, despite repeated interview requests. Over the course of a week the interviews addressed three major allegations: one, that Goldman duped AIG and, subsequently, the U.S. government, into paying fully for credit-default swaps insuring mortgage securities; two, that it took short positions on the collateralized debt obligations that it had created and sold to clients (thereby betting against them); and three, that it stuffed these CDOs with inferior mortgage assets that ensured their collapse.

The defense mounted by Goldman lacks critical details, a consequence, the firm argues, of its overriding need to protect the confidentiality of its clients. But the overall message was emphatic and unified: Goldman did nothing for which it owes anybody an apology—and it doesn't owe anybody any money, either. Its brilliance has been wildly overestimated. Goldman managers were smart, but not that smart. Above all, Goldman insists it played by the same rules as everyone else.

By way of background: Twelve years ago, right out of college, I worked at Goldman Sachs for two years. The training program was all about culture. Keep your head down. Never get your name in the newspaper. Wear conservative blue or white Oxford shirts and don't ever be ostentatious in public. Goldman, the partners told us, swore by the corporate philosophy of "long-term greedy," as set out by the revered Gustave Levy, senior partner at the firm in the early 1970s. The stated ethos was to turn down easy money and build relationships. So walk on eggshells, kid—and fix your tie.

Within months of my start date in 1998, Goldman was going through a vigorous internal debate over whether to

**"THIS HAS BEEN ONE OF THE MOST FRUSTRATING EXPERIENCES OF MY 30 YEARS WITH THE FIRM"**

*—DAVID A. VINIAR, CHIEF FINANCIAL OFFICER*

go public. Some warned that this would open up the storied partnership to untenable scrutiny from the outside world. With brokerage commissions disappearing and hedge funds coming into their own, did Goldman Sachs need to ratchet up its risk profile so it could continue to be a major player on Wall Street? Or should it consolidate its gains and be more of a humdrum asset manager?

Goldman did go public in May 1999, and while management assured shareholders the firm would continue to derive the bulk of its revenue from investment banking and asset management, Goldman did increase its risk profile and, under Blankfein's leadership, rapidly reorient itself from banking to trading. Profits soared, and the firm built a new headquarters. Situated just northwest of Ground Zero, it is heavily guarded—men in blazers with walkie-talkies abound—and you would be hard-pressed to find the words "Goldman Sachs" anywhere within, save for maybe the pencils in the supply cabinet. The place is foreboding and hush-hush quiet.

After taking three pre-programmed elevators, accompanied by a series of well-groomed handlers, I was escorted to a conference room with giant windows and views of AIG's famous tower on Pine Street (which it sold last year).

I was greeted by Schwartz, 46, whose division brought in about 78% of the firm's overall revenue last year. That includes the trading of stocks, bonds, currencies, commodities, and derivatives like CDOs—those pools of subprime mortgages on which AIG provided credit protection and which proved to be the insurer's undoing. Schwartz, more suburban tee-ball coach than Hermès-clad master of the universe, had just broken his shoulder while skiing. His arm was in a sling.

The conversation was genial and moved briskly to the most serious and widely repeated charge against Goldman: that it preyed on the poor judgment of AIG by buying more credit-default swaps from the company than it could ever conceivably pay out and then drove the company into insolvency by demanding that it post collateral for its deteriorating positions.

Defending Goldman, Schwartz grew agitated. "The notion that Goldman Sachs took down AIG is one of the greatest fallacies of the entire crisis," he insists, one open palm flailing in the air. "It's categorically impossible for us to take down a firm."

The AIG-related charges against Goldman go further. Critics such as AIG's former chief executive, Maurice R. "Hank" Greenberg, have contended that Goldman caused AIG's demise and that Goldman should have known, as basic due diligence, that AIG was in way over its head.

Hogwash, says Goldman. Although in hindsight it appears obvious that AIG was a patsy, that was not known when those deals were made. At that time, AIG was widely regarded as the world's foremost insurance company, with a triple-A credit rating. It sold all manner of insurance on U.S. mortgage bonds to investment banks, including Merrill Lynch (now subsumed by Bank of America), France's Société Générale, and Germany's Deutsche Bank. Goldman insists that it didn't know AIG was in trouble until the third quarter of 2007 when it was too late. "AIG was premier, most creditworthy, and most sophisticated—they looked like the perfect counterparty," says Broderick, Goldman's chief risk officer, whom I spoke to on the phone. "I had honestly no conception until late in the process that AIG was in as bad straits as they were."

Some of the deals with AIG, says Goldman, were plain vanilla. In those, Goldman created CDOs by acquiring pools of mortgage-backed bonds. Goldman says it then hedged these positions by purchasing insurance from AIG's Financial Products unit in the form of credit default swaps. In other cases the deals were more exotic, with hedge funds looking to short the mortgage market coming to Goldman for help in structuring a derivative trade known as a "synthetic CDO." From 2005 to 2007, Goldman issued $32.6 billion worth of both types of CDOs. As part of its insurance contract, AIG agreed to pay collateral to Goldman if the market value of a CDO dipped by more than 4%. Goldman checked the market prices daily and made numerous collateral calls on AIG beginning in mid-2007. By September 2008, Goldman had $7.5 billion of AIG's money and claimed it was owed an additional $2.5 billion.

The incessant collateral calls caused the relationship between the two financial giants to deteriorate, with AIG claiming Goldman marked its CDOs lower than other banks' and that it refused to accept the assessment of neutral third parties. (AIG declined to comment.)

**"THE NOTION THAT GOLDMAN SACHS TOOK DOWN AIG IS ONE OF THE GREATEST FALLACIES OF THE ENTIRE CRISIS. IT'S CATEGORICALLY IMPOSSIBLE FOR US TO TAKE DOWN A FIRM."**

***—HARVEY SCHWARTZ, GLOBAL SECURITIES***

Goldman's counter-argument is that its CDO marks were properly conservative, and that it did what other banks would later be criticized for neglecting to do. Competitors dragged their feet in marking down their CDOs because it would have required them to take losses on their entire mortgage inventories.

In the end, Goldman asserts, the secret to its success was not that it was smarter than AIG or could divine the future any more clearly or that it had all those government connections



# FOOD COMPANIES COME TO THIS FRENCH VILLAGE TO WORK ON SECRET RECIPES.

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that enabled it to get paid in full. Rather, Goldman's advantage, it says, was that it did the dull, unglamorous work of repricing its securities at true market value, a Goldman hallmark since its days as a tight-knit partnership, when screwups came right out of partners' capital. Although that's not the case anymore, Viniar, the CFO, says the approach he takes is the same. "I personally see the profit-and-loss statement of each of our 44 business units every single night," says Viniar. At a now-legendary meeting on Dec. 14, 2006, he says, Goldman executives, jittery after 10 straight days of losses in their mortgage portfolio, "literally went through almost every position we had on the mortgage desk."

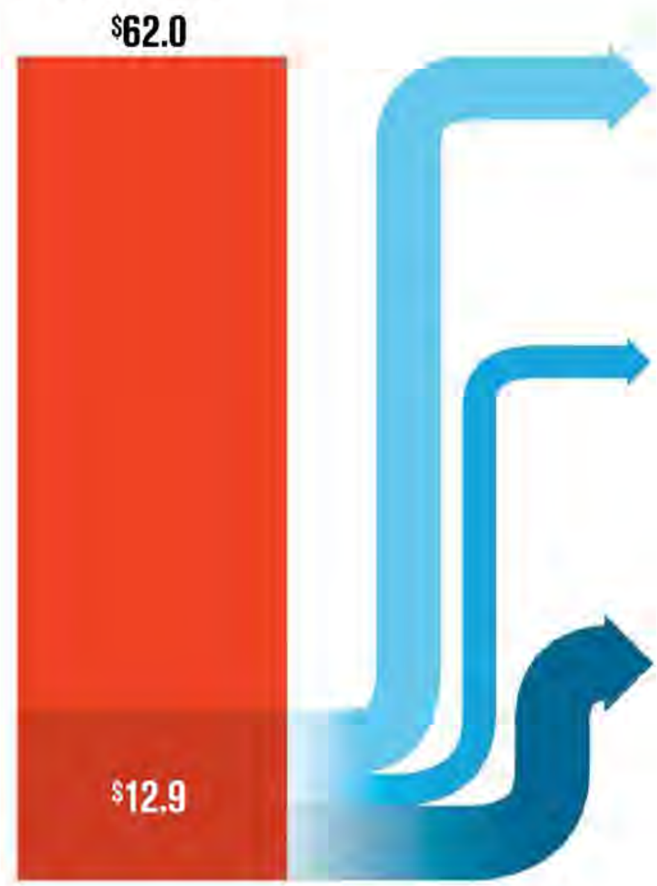
That's when the decision was made to pare back Goldman's exposure to the housing market. Contrary to popular belief, the firm did not make an about-face and short the market. Rather, the decision was to take a neutral position. "I wish we knew as much as people are giving us credit for knowing," says Viniar. "Nobody—certainly not us—knew the depths of the financial crisis we were going to face."

## ABOUT THAT $12.9 BILLION

**Two months after the Federal Reserve bailed out insurer American International Group, the Fed set up Maiden Lane III to buy the mortgage securities AIG had insured. This way the Fed would not have to pay collateral to Goldman and others, as AIG was doing pre-bailout. Here's how the math worked:**

Data: Goldman Sachs

**FED PAYS A TOTAL OF $62 BILLION TO AIG**




Beyond duping AIG, Goldman has been accused by Greenberg and others of selling mortgage securities to pension funds and other investor clients, then shorting the market. In other words, it has bet against its own clients.

Schwartz, exhaling loudly, says the very notion reveals a fundamental misunderstanding of Goldman's reason to exist: market-making, or connecting buyers with sellers. In the ebb and flow of the market, buyers and sellers can't always be immediately matched, so market makers often have to step in with their own capital to execute a trade for a client who demands one. Market-making has its attendant risks, but these are cushioned by fees on the trade flows in both directions. Although market-makers don't necessarily make a directional bet on the market, they do often lean one way or the other. But, Goldman insists, it never took a big, one-way directional bet against the mortgage market. When it went short, Goldman says it did so chiefly to allow clients to bet that mortgage securities would plummet. It facilitated such deals by first buying mortgages with its own money. To protect its hide, Goldman then went out in the market to buy credit default swaps, putting it in a position to demand collateral if its own long position went south.

Although Goldman refuses to identify specific clients, multiple sources familiar with its business confirm that investors helped by Goldman in shorting the mortgage market included now-famous hedge fund manager John Paulson, whose fund made $20 billion over two years by betting that subprime mortgage prices would crater. Dr. Michael Burry, another mortgage-market seer and a prominent character in the Michael Lewis book *The Big Short*, was also a Goldman client, according to these same sources.

Viniar won't say that Goldman never took a short position on securities it sold to clients—"I could never use the word never," he says. Viniar's point is that it wasn't standard practice, that Goldman didn't tell clients to do one thing while it did the opposite.

In part, says Viniar, that was because there was hardly consensus within Goldman about the state of the housing market. The decision after that 2006 meeting was to pare its mortgage exposure and come "closer to home," meaning a more neutral stake. "We were less long in 2007 to 2008, and that clearly saved us billions in potential losses," points out spokesman Samuel Robinson. "We still lost money, but less than we would have otherwise."

Having adopted a neutral policy on mortgages, says Schwartz, Goldman continued to sell mortgage securities to clients who believed prices would keep climbing. Goldman would never have imposed its bias on clients. "You can't be so arrogant as to accept one view over another, or to abandon

STANFORD KAY

## OF THE $62 BILLION, $12.9 BILLION GOES TO GOLDMAN

### $4.8

Of the $12.9 billion, **$4.8 billion** was to settle a securities lending agreement with Goldman in which it had lent AIG cash and, in return, AIG had pledged U.S. government agency securities as collateral. In other words, Goldman could have sold the securities and paid itself.

### $2.5

Of the remaining $8.1 billion, **$2.5 billion** was owed to Goldman under its collateral deal with AIG. After the bailout, the mortgage securities AIG had insured continued to decline in price, triggering the collateral payouts.

### $5.6

The remaining **$5.6 billion,** Goldman says, was used to pay off its own counterparties—hedge funds and other clients that had placed bets on the mortgage market. Goldman won't say who they were.

your market-making role when clients expect you to make markets every day," says Schwartz.

If the firm had acted more like some James Bond villain conspiring to plunder Main Street—as has been alleged by the ideologically diverse likes of Glenn Beck, Michael Moore, and Rolling Stone's Matt Taibbi—it could surely have made a ton of money shorting the doomed mortgage market, say Goldman executives. The firm's mortgage-related revenue from 2003 to 2007, says Schwartz, was less than 2% of total revenue—chump change. That includes underwriting and trading of residential mortgage bonds and CDOs, both for clients and Goldman's own account. In 2008, Goldman actually lost $3.1 billion on its mortgage-related positions.

Goldman also says that, with one minor exception, it never sold CDOs at a retail level, to pension funds or municipalities, and instead dealt only with hedge funds, insurance companies, and large financial institutions, so-called qualified buyers that, under SEC rules, are expected to understand the risks.

In its letter, Goldman will stress that its CDO customers had access to expert advice and research. The only pension fund that bought its CDOs was a large, corporate-related fund long active in this area, and it only bought $5 million worth. (Goldman declined to name the company.) These investors, Goldman executives say over and over again, in telling unanimity, were "sophisticated." Blankfein himself used the word several times in his contentious Financial Crisis Inquiry Commission testimony on Jan. 13. The adjective is tactically (and somewhat tactfully) employed to argue that these clients were fully consenting adults and that Goldman cannot be held responsible for facilitating their bad decisions.

The third major allegation against Goldman gets right into the dirty details of what went into the CDOs, or what became known as toxic mortgages. Critics such as Janet Tavakoli, president of Chicago advisory firm Tavakoli Structured Finance and a onetime Goldman mortgage analyst, accuse the firm of cynically loading them up with bad loans so that when they blew up the firm could profit from the insurance it took out from AIG. Tavakoli notes some of the mortgage pools underlying Goldman-arranged CDOs were downgraded within six months of the issue—a telltale sign, she says, that Goldman was gaming a weakening system.

To Tavakoli, Goldman was, in some cases, able to take advantage of a flaw in the CDO system: AIG wrote credit protection on the basis of a mythical triple-A rating, while Goldman's calls on AIG's cash were based on its reality-tested valuations of the underlying mortgages. In other words, Goldman could quickly squeeze AIG for cash by marking down the mortgages underlying a CDO insured by a credit-default swap from AIG. Goldman created a no-lose situation for its clients, at AIG's expense.

"Now," says Tavakoli, indignantly, "Goldman is trying to pretend it didn't know any better, while also trying to say they are great risk managers. Goldman cannot have it both ways."

Here again, Goldman officials claim they were simply servicing the needs of clients. "There was a lot of back and forth with the client, whether a hedge fund or someone else, to shape the needs of that client," according to a Goldman official who requested anonymity because he doesn't want his name in the press. "We were facilitating a client inquiry. But clients never dictate terms." Because of Goldman's refusal to reveal the names of clients it was actually working on behalf of, this position is impossible to confirm. Such is the opacity of modern

**"I HAD HONESTLY NO CONCEPTION UNTIL LATE IN THE PROCESS THAT AIG WAS IN AS BAD STRAITS AS THEY WERE"**

***—CRAIG BRODERICK, CHIEF RISK OFFICER***

Wall Street firms; you can never quite tell when the firm is trading on behalf of its clients or on its own account. This opacity works very much to the advantage of the firms.

On one point regarding its CDO performance, however, Goldman has third-party backing. A study of about 700 CDOs underwritten between 2002 and 2007 concluded that Goldman's CDOs performed better than all other major underwriters'. JPMorgan Chase's rate of default was four times higher. That academic study did not come with elite bona fides; the author was a senior at Harvard University who has since been hired by Goldman.

For all of Goldman's critics, some believe the firm deserves credit for keeping its eye on the ball, especially at a time when money was pouring in and competitors were getting lazy. "The frikkin' CFO of Goldman Sachs actually hauled the mortgage traders into his office and talked to them," says Kenneth Posner, the former head of Morgan Stanley's financial services research group and author of the book *Stalking the Black Swan*. "Other banks just did not roll up their sleeves that way."

But even Posner asserts that Goldman would have been a goner if the Fed didn't throw it a life preserver by paying off AIG's credit default swaps at 100¢ on the dollar and giving Goldman bank-holding-company status, which allowed it to borrow from the Federal Reserve at near-zero interest rates. Moreover, Goldman's $10 billion in TARP funds, since paid back with interest, helped it maintain the aura of solvency at a time when the mere perception of weakness could have caused a run on the bank.

Goldman vigorously disputes that it could not have survived if the government hadn't paid it in full. Of the $12.9 billion it received, Goldman produces math showing that only a relatively small amount—$2.5 billion—was actually a new transfer of funds to the firm itself. Goldman used some of the rest (chart, page 36) to close out a loan to AIG for which Goldman had full collateral. The remainder Goldman paid to its own counterparties to acquire the mortgage securities underlying the credit default swaps AIG had written, which Goldman handed over to the Fed. So while the firm certainly would not have wanted to receive less than a full payout, its survival did not depend on it. This, it contends, quashes the notion of a back-door bailout that saved Goldman from extinction.

Talking to top Goldman executives, I couldn't resist asking the obvious question: If the firm could just write a multibillion-dollar check to erase the outrage—deserved or not—over the AIG payout and be done with the public agony, wouldn't it just do it? The question elicited sighs of exasperation and created some tension; I just wasn't getting it. No, was the answer. The executives all agreed that would be an implicit admission of guilt, and Goldman Sachs isn't guilty of anything.

In a Feb. 26 filing with the SEC, Goldman acknowledged that "adverse publicity can have a negative impact on our reputation and on the morale and performance of our employees, which could adversely affect our businesses and results of operations." Officials say that several times the Justice Dept. has requested information soon after negative stories have appeared in the press. Eyebrows were certainly raised when the Treasury Dept. in late March chose Morgan Stanley over Goldman Sachs to handle the lucrative business of selling off the government's $32 billion stake in Citigroup. Might Goldman's tarnished reputation have caused it to lose out? Goldman won't say whether it bid on the job, though a government official confirms that it did.

Speaking about prospects more generally, Viniar says Goldman's decision to explain its motives and actions during the crisis isn't fleeting, that it is committed to changing its popular image. "We believe our franchise is as strong as it has ever been and that our clients, our people, and our shareholders are happy with our performance," he says. "But we're also very aware of public opinion and the backlash against Wall Street, and we're doing our best to address it."

When Goldman Sachs went public in 1999, the firm issued a statement about its business objectives. "While we plan to continue to grow our trading businesses, the financial-market shocks of the past year underscored the importance of our strategy of emphasizing growth in our investment banking, asset management and securities services businesses," the statement read. "Through a greater relative emphasis on these businesses, our goal is to gradually increase the stability of our earnings." The statement was an attempt to assure future shareholders that the Goldman culture would endure, that an investment in the firm that brought Ford Motor public and was crucial to so many American business success stories, would be a rock-solid investment. Goldman would be different from firms like Salomon Brothers that lived off the quick-hit profits of the trading desk.

A decade later, the percentage of revenue derived from trading and principal investment has ballooned from 55% to 76% in 2009. Business is booming, but Goldman, which once prided itself on avoiding the ostentatious and on making money for the long haul, is a different firm, with a perception problem that mere explanation can't solve. In committing to market-making at all costs, the firm has opened itself up to forces beyond its control. The question is: Has Goldman Sachs shorted itself? | BW |

**"I PERSONALLY SEE THE PROFIT-AND-LOSS STATEMENT OF EACH OF OUR 44 BUSINESS UNITS EVERY SINGLE NIGHT,"**

***—DAVID A. VINIAR, CHIEF FINANCIAL OFFICER***



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An Indian family inspects a new Figo at a dealership in South Bangalore



# ALAN MULALLY'S ASIAN SALES CALL



**Making up for lost time, the Ford CEO is boosting investment, production, and marketing in fast-growing China and India**

**By Bruce Einhorn**

**Photography by Namas Bhojani**

Since its earliest days, Ford Motor has missed opportunities in Asia. In 1924, Henry Ford declined an invitation from China's first president, Sun Yat-sen, to help the country build an auto industry. Even in the 1990s, when Deng Xiaoping's reforms gained momentum and foreign investment poured into China, Ford hesitated; it didn't make cars there until 2003. In India, too, the company shunned a government request to create a manufacturing hub in the 1930s. Only in 1996 did Ford autos roll off an Indian assembly line.

None of that history fazes Ford CEO Alan Mulally, who is not about to let his predecessors' missteps keep him from seizing the day. "Now we are here," he declares while visiting the Dongchang Ford dealership on Jinshajiang Road in Shanghai recently. Climbing behind the wheel of a Fiesta sedan, he points to the yellow stitching on the black leather seat. "See the trim? Chinese really like the stitching," he says. The compact comes with a sunroof—a must in a coun-

try where many people smoke. Launched in March 2009 with a starting price of $11,700, the Fiesta is the type of car that used to be thought of as "cheap and cheerful," says Mulally, 64. Ford designed it with Chinese car lovers in mind. They "are really discriminating," he notes. "[Chinese] want their small cars to be really neat."

The Fiesta is one of two new weapons in Mulally's battle to reverse Ford's disappointing performance in Asia. The other is the Figo, a $7,700 hatchback developed over two years for India and launched this past March. Mulally, a former Boeing executive who nurtured that company's relationship with China before joining Ford in 2006, is hoping the new models will change the odds for Ford in the region. The company controls a mere 2.6% of the China auto market, the world's largest, and only 2% of India, Asia's No. 3 after China and Japan. "Over time, we will gradually, continually grow our share," he predicts.



CEO Alan Mulally is serenaded at the September 2009 groundbreaking of a new Ford plant in Chongqing

### "HIGHEST PRIORITY"

While Mulally can take credit for avoiding bankruptcy and a government bailout last year, he knows that to thrive, the automaker has to get serious about improving its game in Asia. Soon, according to market researcher J.D. Power & Associates, a third of the world's auto sales will come from the region spanning China, India, Northeast Asia, Southeast Asia, Australia, and New Zealand. Today, that region accounts for just 11% of Ford's sales, vs. more than 25% for General Motors. "The market is going to be led by Asia-Pacific," Mulally says. "I have made it the highest priority for Ford."

He has invested over $2.2 billion in Asia since coming to the company. That includes a $500 million expansion of a plant in Thailand that Ford and joint venture partner Mazda opened last year to make Ford Fiesta and Mazda2 compact cars. (Ford owns 13% of the Japanese company.) Mulally's chief concern is China and India, which by 2015 could account for a quarter of the world's auto sales. "Apart from the U.S., these two are the defining markets for global success," says Mohit Arora, executive director of J.D. Power Asia Pacific. "If Ford is looking for a strategy for survival, these two markets are absolutely essential," he adds.

The automaker is making up for lost time and doubling down on its core brand. On Mar. 28, Ford agreed to sell its Volvo unit to China's Geely for $1.8 billion—cash that could help fund its Asia expansion. The deal followed Mulally's meetings in the region with business and government leaders, including Chinese Premier Wen Jiabao. In December, Ford moved its Asia-Pacific headquarters from Bangkok to Shanghai, a shift made to emphasize the company's commitment to China. Last September, Mulally traveled to Chongqing in southwestern China to break ground on a new $490 million auto factory, Ford's third in the country. The same month, he visited a new $500 million plant in the southern Indian city of Chennai.

Ford's investments have boosted its capacity by 50% in China and 100% in India since 2007. (It can now build 450,000 cars a year in China and 200,000 a year in India). That's only the beginning of the growth Mulally wants to see. "China is growing so fast that our challenge is to main-



**Fiesta**
China was one of the first markets for the Fiesta (left), which was launched last year. With a 1.3 or 1.5 liter engine, the compact comes in sedan and hatchback versions and starts at $11,700.



**Figo**
Starting at $7,700, the Figo (right) is Ford's lowest-priced car in India. The hatchback comes with a 1.2 liter or 1.4 liter engine and is Ford's answer to Chevrolet's new Beat model.

(TOP) PHOTOGRAPH BY DOUG KANTER/BLOOMBERG

tain market share just because of our capacity limitations," says Lewis Booth, Ford's chief financial officer. To remain competitive, Ford is trying to use more local suppliers. The company is sourcing 85% of the Figo's components from Indian companies and aims to purchase at least 90% of its parts in China locally, says Jeffrey Shen, CEO of Changan Ford Mazda Automobile, the company's manufacturing joint venture in Chongqing.

Mulally is leading an expansion of Ford's dealer base as well. The company plans to add at least 70 outlets in China this year, bringing its total to 310. In India, Ford expects to increase its 167-strong dealer network by 10% to 15%. Joseph R. Hinrichs, president of Ford Asia-Pacific, calls Mulally's Asia push "an aggressive growth strategy."

When Mulally left the dealership in Jinshajiang Road, the magnitude of his challenge came into view. Flanking the Ford dealership on the bustling strip were rivals selling Volkswagen, Buick, Hyundai, Citroën, Lexus, Subaru, and Mazda—most of whom outsell Ford in China. Tied for No. 11 in China with local companies Geely and FAW, Ford trails not only market leaders such as VW and GM but also second-tier players such as Japan's Suzuki, says J.D. Power. Suzuki is the top player in India, where its Maruti Suzuki subsidiary dominates the market with a 53% share (charts). "The competition is quite fierce now," says Qiu Wuwei, deputy general manager of the Dongchang Ford dealership, which was decorated with hanging lanterns for the Chinese New Year and attracting a handful of customers on a quiet Thursday morning.

Some of the people kicking tires were mostly curious; Chinese aren't familiar with Ford and tend to be wary about buying American. It's like buying a Geely in Galveston, a Chery in Chippewa Falls. It isn't usually done, at least not yet.

## FORD TRAILS IN ASIA'S TWO BIG MARKETS



Data: J.D. Power & Associates

CHART BY STANFORD KAY

### FAMILY AFFAIR

Still, business has been picking up, thanks to the Fiesta. Ford sold 47,000 Fiestas and scored a 55% increase in its passenger car sales, to 316,000, in 2009. At the Dongchang dealership, sales are so brisk that Qiu has hired seven new salesmen. Some 70% of Ford's customers are first-time buyers, and often the whole family comes along to shop. Harriet Luo, 33, a teacher in Shanghai, brought her husband, parents, and in-laws when she checked out cars at the dealership recently. She had already considered models by Toyota, Volkswagen, Hyundai, and Chery, when she settled on a Ford Focus, the first car for anyone in the family. "I'm very excited. I couldn't sleep well last night," she says, as she waits to drive her new car off the lot.

Ford executives concede they face a problem selling Chinese on their brand: There aren't enough choices. The company's offerings are limited to the Fiesta, the midrange Focus, the top-end Mondeo, and the S-Max minivan. By 2013, Ford aims to add four more models. "Every year or so," Mulally promises, "we're going to bring out another vehicle for Chinese customers."

Ford is crafting a similar strategy for India, where the company plans a new model every 12 to 18 months. For now, Ford is counting heavily on the Figo. The car was designed for a hypothetical twentysomething Indian named Sandeep. He works in IT, finance, or another service industry and tools around on a motorcycle. But now that he is enjoying the first fruits of affluence, Sandeep wants four wheels. "There are huge numbers of people wanting to move off their motorbikes," says Ford India General Manager Michael Boneham, who calls the Figo a "game changer." Some 70% of cars sold in India are in the same size and price range. "We haven't been there until now," he adds.

Ford may be changing its game too late. VW put its compact, the Polo, on the market in February. GM launched its new Chevy Beat in January, two months before Ford unveiled the Figo. A small sedan that starts at $7,600, the Beat is so popular there's now a two-month waiting list for it in India, says GM India President Karl Slym. To keep up with demand, the company has added a second shift to its factory near Pune in western India. GM sold 69,000 cars in India vs. Ford's 29,500 last year, and Slym expects growth of 50% in 2010.

In China, too, GM plans 10 new models this year. VW, the market leader, aims to invest $5.4 billion over the next three years and launch seven locally-produced models in 2010. China is a "war of attrition" for the automakers, says Michael Dunne, president of Hong Kong-based auto consultant Dunne & Co. "It's going to be a grind in the next few years, with everyone clawing for more market share. The companies with the deepest pockets will be the ones left standing," he adds. Dunne predicts Ford will have to invest at least $1 billion in China to double its capacity and $500 million in India to lift capacity by about 75%.

Thanks to Mulally's efforts to shore up Ford's finances, the company's resources to spend in Asia are growing. After losing $30 billion from 2006 through 2008, Ford earned $2.7 billion on sales of $118 billion last year, and analysts expect profits of $3.6 billion in 2010. "We started a little late here," Mulally acknowledges. When it comes to Asia, "clearly, the importance cannot be overstated." |BW|

THERE ARE SOME THINGS MONEY CAN BUY, AND ONE OF THEM IS A LICENSE TO ISSUE CREDIT CARDS FROM MASTERCARD AND VISA. SOME QUESTIONABLE BANKS DO JUST THAT, GAINING CREDIBILITY FROM THE BRANDS WHEN THEY'RE REALLY JUST...

# CARD SHARKS

**By Jessica Silver-Greenberg**
**Illustration by Eddie Guy**

Hallmark Bank & Trust, headquartered in the Turks and Caicos islands, enjoys a valuable relationship with one of the best-known brands in consumer finance: the credit-card giant MasterCard. Hallmark, like other banks, pays MasterCard for the right to use its name on the cards Hallmark issues to customers. MasterCard also receives a percentage of sales made with those cards.

Hallmark, despite its homespun name, has a checkered reputation. (It has no connection to the greeting card company.) In a civil lawsuit filed in 2007 in federal court in Hawaii, the U.S. Internal Revenue Service alleged that two American accounting firms advised scores of clients to evade taxes by moving money out of the country by means of Hallmark-issued MasterCards. The bank isn't named as a defendant in that case. Brian F.J. Trowbridge, Hallmark's president, formerly served as a director of Lake Shore Alternative Financial Asset, also based in the Turks and Caicos. In February 2009, a federal grand jury in Chicago accused the president of Lake Shore affiliate Lake Shore Asset Management, Philip J. Baker, of tricking U.S. currency investors out of a total of $300 million. Trowbridge isn't accused of criminal conduct in the case. Until recently, another Hallmark executive, Greg Hurd, secured banking services for Lake Shore Asset Management, according to a document filed in a 2007 civil fraud suit brought against Lake Shore Asset Management by the U.S. Commodity Futures Trading Commission in federal court in Chicago. Baker and Lake Shore have




MasterCard
VISA
MasterCard
VISA

denied wrongdoing in the Chicago cases, which are pending.

All of this raises a question: How many red flags does MasterCard need before severing ties with Hallmark Bank and its president?

MasterCard and its main rival, Visa—each a publicly traded company—say they monitor individual cards for misuse and avoid associating with questionable banks. The vast majority of banks that have alliances with Visa and MasterCard boast solid reputations. But the card companies also do business with financial executives and institutions that have murky profiles.



Visa has sold a debit-card license to Global Bank of Commerce in Antigua. On its Web site, Global markets an "unembossed" Visa card on which the customer does not have to place her name. Other financial companies make similar anonymous card offers. A. Jack Fishman, a former IRS criminal investigator, says the come-ons appeal to people who use cards to evade taxes or transfer dirty money: "Why else on earth would you need an anonymous credit or debit card, unless you were trying to move illicit funds?" Global's president, Brian Stuart-Young, says the no-name cards aren't likely to be used illegally because the bank "holds detailed financial information for anyone who might get an unembossed card." The cards typically have low limits, he adds.

### "REPUTATIONAL CONCERNS"

The card networks stress that they take special care when dealing with banks outside of the U.S. In an e-mailed statement, Visa, based in San Francisco, said it "reviews the owners and directors of each non-U.S. applicant [bank] against applicable government lists and commercial databases to ensure that there are no restrictions or reputational concerns associated with the applicant." A Visa spokesman declined to address the company's relationship with Global or to make Visa executives available for interviews.

Jodi Golinsky, MasterCard's vice-president for U.S. regulatory and public policy, says her company combs through banks' public records and conducts independent investigations. The roughly 23,000 banks currently approved by MasterCard are also subjected to ongoing monitoring, she adds. MasterCard requires each to have an active program to fight fraud and money-laundering. Banks based in countries or regions known to be tax havens receive extra attention.

So how is it that Hallmark has maintained a valuable 11-year relationship with MasterCard? Golinsky says the card company knows about the legal entanglements of Hallmark and its employees. Beyond that, she declines to comment.

Reached by phone, Hallmark employee Cara Saunders says the bank is in the midst of a move and no one can comment. Trowbridge, the president, responded via e-mail: "We cooperated with the IRS in the Hawaii matter, and no charges were ever made against Hallmark." He added: "Hallmark and I actively and fully support anti-money laundering activities. Nor do we engage in, or encourage, tax evasion." On Lake Shore, he said: "Hallmark provided registered offices for Lake Shore. We did not trade [its] accounts, solicit funds, or have contact with investors." Trowbridge added that Hurd is no longer an employee of Hallmark and that neither Hallmark nor Hurd ever provided financial services to Lake Shore or its president, Baker. Messages left at Lake Shore went unreturned. Baker is in custody in Chicago awaiting trial. His attorney didn't return messages.



Trowbridge says Hallmark (right) supports efforts against money laundering

Visa and MasterCard authorize tens of thousands of banks around the world to issue a total of more than 1 billion cards. On its Web site, Visa highlights its anti-fraud technology, saying its highest priority is "protecting merchants, cardholders, and financial institutions from payment card fraud." MasterCard, based in Purchase, N.Y., says on its site: "Consumers worldwide use MasterCard cards for more than 16 billion transactions a year, and all but a minute percentage of those transactions are fraud-free."

Still, credit-card misuse crops up not only at obscure Caribbean banks but at large mainstream ones as well. UBS, the Swiss titan, agreed in February 2009 to pay $780 million to avoid prosecution by the U.S. Justice Dept. for allegedly helping wealthy Americans evade taxes on roughly $20 billion. Most of the UBS accounts in question had credit cards attached to them, which allowed customers to gain access to the sheltered money, according to prosecutors. Jeffrey P. Chernick of New York, one of the first to be individually charged with evading taxes through a UBS account, pled guilty last July to hiding $8 million from U.S. tax authorities. In his plea agreement, Chernick admitted to using a credit card to avoid taxation. The brand of the card wasn't specified in court papers. Chernick received a reduced sentence of three months in jail in exchange for cooperating with authorities.

MasterCard's Golinsky says her company isn't working with authorities on any matters related to UBS or Chernick. She otherwise declines to comment on specific cases. MasterCard cooperates with government investigators in such situations,

**CARD COMPANIES SAY THEY MONITOR BANKS THEY LICENSE, ESPECIALLY THOSE IN TAX-HAVEN JURISDICTIONS**

(THIS PAGE) WEEKLY NEWS (RIGHT) JEFFERY SALTER/REDUX

she says. Banks "are regulated entities and therefore governed by the appropriate authorities," she adds. Golinsky declines to disclose how many bank licenses MasterCard has revoked because of concerns about impropriety.

Sometimes, even after regulators sue a financial executive, the action doesn't seem to set off alarms with Visa or MasterCard. Johnny E. Johnson is the COO of Sun Investment Savings & Loan, which is registered in Sweden. On its Web site, Sun says that it issues MasterCard debit cards. In April 2009 the SEC accused Johnson of securities fraud in a civil suit filed in federal court in Los Angeles. The suit, which is pending, alleges that Johnson and other defendants operated a "multilevel marketing scheme" that defrauded individuals of some $9 million.

The Sun executive has a colorful career history. In 1999 regulators in Antigua placed into receivership the bank where he then worked as a managing director. That institution, known as Eurofed Bank, was linked to a Ukrainian money-laundering scandal, according to the Antiguan authorities. Johnson was not specifically accused of wrongdoing but was described by the Antiguan government as the bank's primary manager. John Benjamin, the chief financial regulator for the Antiguan Finance Ministry, declined to provide any more specifics.

Johnson later managed AvantGuard Bank & Trust in Grenada. In 2002, while he was running that bank, the Grenadan Finance Ministry opened an investigation into whether AvantGuard was compliant with the country's banking laws and maintaining sufficient capital. The bank voluntarily liquidated itself the same year. Before dissolving, AvantGuard had offered a MasterCard marketed as the Freedom Card. The card was licensed through a corporate affiliate of AvantGuard. Petra Charles-Joseph, a spokeswoman for Grenada's Finance Ministry, declined to provide additional details.

Asked about Johnson, MasterCard's Golinsky reiterates her employer's no-comment policy concerning specific banks or executives. "We require any [bank] customer to have its own policies and procedures in place to make sure that they have robust anti-money-laundering and compliance," she says. Johnson didn't return phone messages seeking comment. His attorney, Jonathan Schwartz, declined to comment.

David Rowe, a Fort Lauderdale attorney representing 22 investors, says that Hallmark Bank & Trust's tie to MasterCard contributed to his clients being misled. Rowe has filed five lawsuits alleging that Hallmark and an investment firm called Overseas Locket International jointly promised his clients 15% returns on currency trades. The defendants never invested the money, Rowe's clients allege, resulting in losses of $250 million.

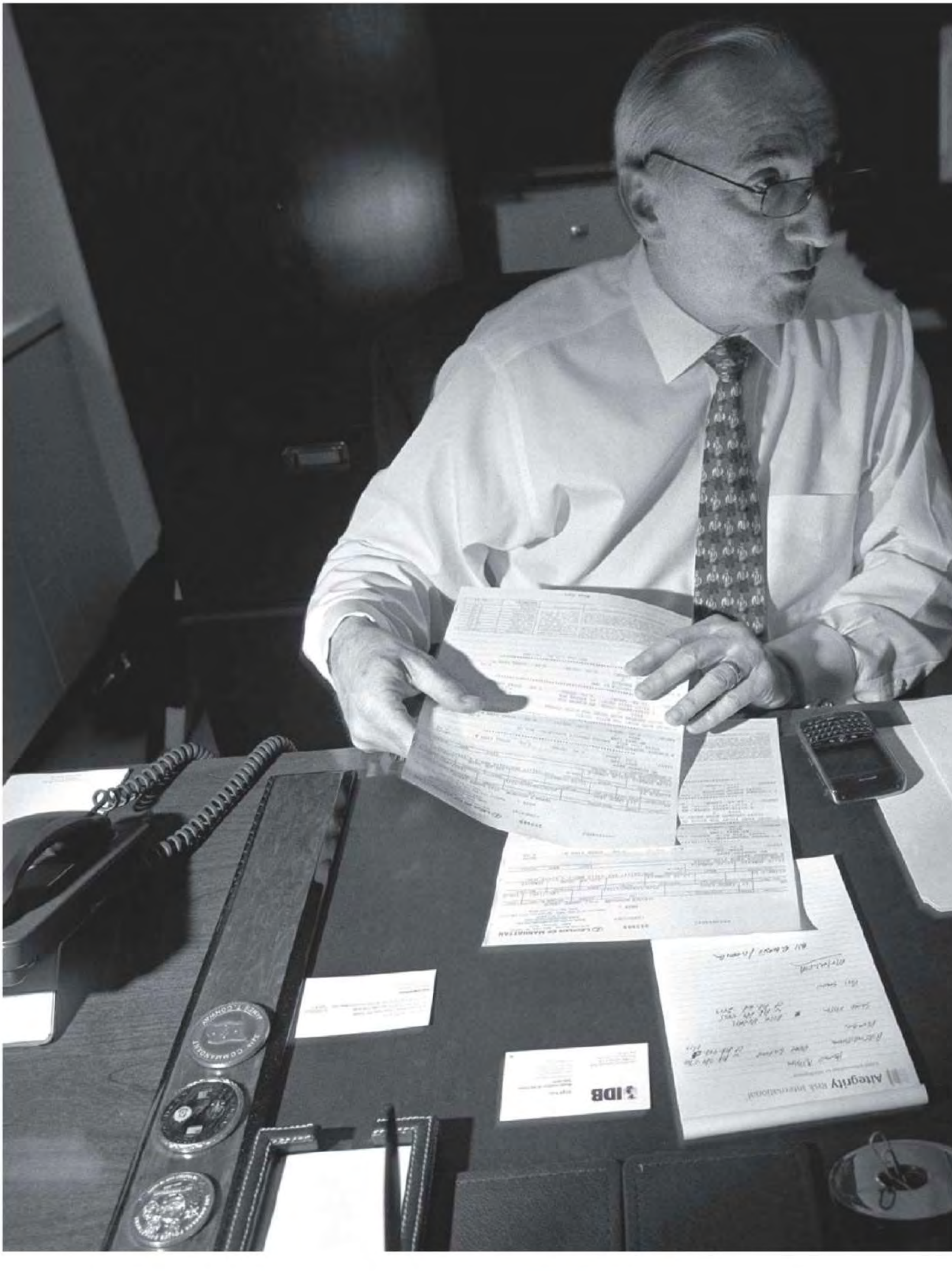
**Rowe's Florida clients say they were impressed by the MasterCard brand**



Rowe argues that his clients were convinced of the legitimacy of the investment in part by Hallmark's association with MasterCard. In an interview, plaintiff Don Dowe says, "I figure that this is a major bank that is being endorsed by MasterCard." Promotional materials sent to investors by Overseas prominently displayed MasterCard's logo, Dowe says.

One of the five suits filed by Rowe was dismissed on Mar. 27 by a federal judge in Fort Lauderdale. The judge ruled that the case should have been filed in the Turks and Caicos, not in Florida. Rowe says he will attempt to revive the dismissed suit and continue to press the others. Hallmark has denied any impropriety. Carl W. Oberdier, a lawyer who has represented the bank in similar litigation in New York, says: "It's tragic what happened to the investors, but Hallmark's view is that Hallmark put a stop to the damages as soon as it could and vigorously worked with law enforcement in the Turks and Caicos."

MasterCard has been named as a defendant in four of the five Florida suits. In court filings, it has denied any wrongdoing. The company's Golinsky declines to comment on the litigation. She says a bank's being accused of wrongdoing could affect whether MasterCard continues to do business with it. Inquiries from law enforcement agencies "prompt a second review." Mastercard, she emphasizes, monitors its licensees vigorously. | BW |


IDB
Altegrity Risk International



# BILL BRATTON, GLOBOCOP

**He tamed crime in New York and Los Angeles. Next stop ... Kabul?**

By Susan Berfield
Photographs by Larry Fink

**Sometime this past summer Bill Bratton realized he was getting bored. He was** nearing his 62nd birthday and wondering what his next challenge might be. He'd spent most of his career in law enforcement. Was it time for another shot at the corporate world? He had been in command of the Los Angeles police force for seven years, the longest he had ever stayed anywhere. Bratton had led the department through grueling, federally mandated reforms. He had put into practice all of his ideas about policing and management and leadership, and they had worked. The crime rate had dropped by more than a third. The LAPD, long despised in minority communities, found acceptance where it had previously been feared. Morale was high. "I had done everything I wanted to do," he says.

What he chose to do next suggests that Bratton still has something to prove, because there are many easier ways to ensure a comfortable retirement. In the fall of 2009 he became chairman of Altegrity Risk International, a security consulting firm in New York. Bratton intends to bring the best of American policing to some of the most dangerous places in the world. Soon the State Dept. will open the bidding on highly lucrative contracts to help train police forces in what it calls post-conflict nations. It's work that has often defied the expertise of more established companies, other law enforcement agencies, and the U.N. It is dangerous, frustrating, politically fraught, and labor-intensive. Bratton, however, is optimistic. In fact, he sounds like a man about to embark

**NEW YORK CITY**
Bill Bratton in his office. Altegrity plans to bid on contracts to train police around the world.



ADAM FERGUSON/VII MENTOR PROGRAM

**AFGHANISTAN**

**Even for a diehard optimist like Bratton, Kabul will pose daunting challenges: The police force is poorly equipped and frequently illiterate, and corruption and drug abuse are endemic.**

on a long-planned vacation. "It's a great time to be doing this," he says in his office in midtown Manhattan. "Some of the fun I can have with this venture is that I still get to advocate for the American success story. And it's an opportunity to have that success validated by making money."

Bratton's philosophy of law enforcement took shape 20 years ago when, as head of New York City's transit police, he inspired and provoked a once-demoralized force to restore order underground. He and a small brain trust believed that police should consider residents their customers, criminals their competitors. They also understood that authority and accountability had to be visible at a local level. Which meant that cops in the squad house needed real-time information that they weren't getting: details about crime patterns and colleagues' responses.

In 1994, New York City Mayor Rudolph W. Giuliani appointed him police commissioner, and although friction with his boss led to Bratton's ouster after two years on the job, his impact was long lasting. During his time as head of the NYPD, serious crime dropped by 33% and the murder rate was cut in half. The Bratton approach includes a data-driven problem-solving process known as CompStat (for computer statistics) that was devised by one of his most influential deputies, the late Jack Maple. CompStat has been widely, if unevenly, embraced by forces around the country.

Today, nearly 15 years after Bratton's career as New York's chief cop ended, he still wears a large gold ring with a replica of his badge. His Altegrity office in Manhattan is full of police memorabilia: his first badge from Boston and miniatures of New York's first police helicopter and California's first black-and-white cruiser. Altegrity, a billion-dollar company owned by the private equity firm Providence Group, has many lines of business: It conducts employment background checks, due diligence, corporate fraud investigations, and risk analysis of all kinds. Altegrity Risk International is a new division. Overall, the company has about 2,800 investigators and its biggest client is the U.S. government. In anticipation of winning a few of the upcoming State Dept. contracts, which could be worth $30 billion overall, Bratton and his staff have been recruiting former police chiefs, cops, lawyers, and judges to handle the day-to-day work overseas.

Altegrity is run by Michael G. Cherkasky, a former New York prosecutor who used to head up Kroll and, after selling it to Marsh & McLennan in 2004, led that firm, too. He was brought in as CEO a year and a half ago to expand the company, which started out as USIS, and prepare it to go public. (Bratton has an undisclosed stake in Altegrity.) Among the businesses that Providence might consider adding to Altegrity is Kroll itself, which is rumored to be for sale for about $1.5 billion.

Cherkasky and Bratton have known each other for years and worked together most recently in Los Angeles, where Cherkasky had been monitoring police department reforms on behalf of the federal government, which had oversight of the LAPD between 2001 and 2009. Both share a bright view of what could be very glum work. "There's nothing inconsistent with winning on Wall Street and doing good things for the world," says Cherkasky. Bratton describes Altegrity as "like the Peace Corps, but better paying."

### MONEY IN CONFLICT

The main contracts from the State Dept. will be to train police forces in 14 "post-conflict" nations, including East Timor, Haiti, and Afghanistan. Altegrity sent a four-person scout team to Kabul in December. "No one is going to confuse Los Angeles with Afghanistan," says Cherkasky. "I hate when people say it's a war on poverty, crime, drugs. War is the fighting in Afghanistan. There are different rules. We understand the differences. We won't solve all the problems, but we're trying to do it better."

The problems in Afghanistan are daunting: Police recruits are often illiterate, corruption is rampant, drug use prevalent, and the training, so far, dangerously inadequate. The State Dept. is trying to address the chaos there and elsewhere by awarding smaller jobs to more companies as a way to assess which approaches work best and reduce the risk of failure. That's the only reason Altegrity stands a chance against companies such as DynCorp and Lockheed Martin, which have had a lock on police training programs. "The State Dept. will CompStat it," says Bratton. "Who's having success? If it worked in the 7-5 [precinct], will it work in the 8-5?" The government wants to encourage competition, says William Loomis, a managing director at brokerage Stifel Nicolaus. And it could be receptive to the Bratton brand name, he says. "Any time you have a service company, the people are what give you the credentials."

Although government contracts are where the big money is, other consulting work, especially in Latin America, could come Altegrity's way. None of it will come easy. "The threshold hurdle will be to establish the legitimacy of authority," says Richard Aborn, a consultant to European police forces and the president of New York's Citizens Crime Commission. "Bill will have to

# "I used to think it was just a phase, until I had 'the talk' with my doctor."



## Your Doctor Talks to Men About ED Every Day



Doctor portrayal.

Actually, erectile dysfunction (ED) is more than just a phase. It's a common medical condition affecting millions of men just like you. But your doctor can help.



## Keys to Opening Up to Your Doctor

The hardest part about having 'the talk' is getting those first few words out. Here are some ideas to help you break the ice when your doctor asks how everything's going:

The Direct Approach:
"I have trouble sometimes in bed. Could it be ED?"

The Indirect Approach:
"Is it true age affects sexual performance?"

The Silent Approach:
Just hand this ad to your doctor, he'll take it from there.

## Running the Numbers

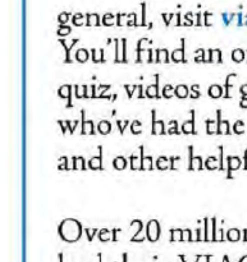
Did you know half of all guys over 40 have some form of ED? Here are some numbers to keep in mind from a recent survey of men with ED:




of men were anxious about talking to their doctor about ED.




of men felt relieved after talking to their doctor.



## Tell Me More

To learn more about VIAGRA for the treatment of ED, and ED in general, visit **viagra.com** today. You'll find an online sexual health quiz, videos of guys with ED who've had the VIAGRA Talk and other helpful information.

Over 20 million men have already had their VIAGRA Talk. Isn't it time you had yours?

## Important Safety Information

We know that no medicine is for everyone. Don't take VIAGRA if you take nitrates, often prescribed for chest pain, as this may cause a sudden unsafe drop in blood pressure.

Talk with your doctor first. Make sure your heart is healthy enough to have sex. If you have chest pain, nausea, or other discomforts during sex, seek medical help right away.

In the rare event of an erection lasting more than four hours, seek immediate medical help to avoid long-term injury.

In rare instances, men who take PDE5 inhibitors (oral erectile dysfunction medicines, including VIAGRA) reported a sudden decrease or loss of vision, or sudden decrease or loss of hearing. It is not possible to determine whether these events are related directly to these medicines or to other factors. If you experience any of these symptoms, stop taking PDE5 inhibitors, including VIAGRA, and call a doctor right away.

The most common side effects of VIAGRA are headache, facial flushing, and upset stomach. Less common are bluish or blurred vision, or being sensitive to light. These may occur for a brief time.

VIAGRA does not protect against sexually transmitted diseases including HIV.

Please see Important Facts for VIAGRA on the following page or visit viagra.com for full prescribing information.

**For free information, including questions to ask your doctor, call 1-888-4VIAGRA (1-888-484-2472).**

VIAGRA®
*(sildenafil citrate) tablets*

***You are encouraged to report negative side effects of prescription drugs to the FDA. Visit www.FDA.gov/medwatch or call 1-800-FDA-1088.***

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Pfizer

# IMPORTANT FACTS

**VIAGRA®** (vi-AG-rah)
*(sildenafil citrate) tablets*

## IMPORTANT SAFETY INFORMATION ABOUT VIAGRA

Never take VIAGRA if you take any medicines with nitrates. This includes nitroglycerin. Your blood pressure could drop quickly. It could fall to an unsafe or life-threatening level.

## ABOUT ERECTILE DYSFUNCTION (ED)

Erectile dysfunction means a man cannot get or keep an erection. Health problems, injury, or side effects of drugs may cause ED. The cause may not be known.

## ABOUT VIAGRA

VIAGRA is used to treat ED in men. When you want to have sex, VIAGRA can help you get and keep an erection when you are sexually excited. You cannot get an erection just by taking the pill. Only your doctor can prescribe VIAGRA.

VIAGRA does not cure ED.

VIAGRA does not protect you or your partner from STDs (sexually transmitted diseases) or HIV. You will need to use a condom.

VIAGRA is not a hormone or an aphrodisiac.

## WHO IS VIAGRA FOR?

Who should take VIAGRA?

Men who have ED and whose heart is healthy enough for sex.

Who should NOT take VIAGRA?

- If you ever take medicines with nitrates:
  - Medicines that treat chest pain (angina), such as nitroglycerin or isosorbide mononitrate or dinitrate
- If you use some street drugs, such as "poppers" (amyl nitrate or nitrite)
- If you are allergic to anything in the VIAGRA tablet

## BEFORE YOU START VIAGRA

**Tell your doctor if you have or ever had:**

- Heart attack, abnormal heartbeats, or stroke
- Heart problems, such as heart failure, chest pain, or aortic valve narrowing
- Low or high blood pressure
- Severe vision loss
- An eye condition called retinitis pigmentosa
- Kidney or liver problems
- Blood problems, such as sickle cell anemia or leukemia
- A deformed penis, Peyronie's disease, or an erection that lasted more than 4 hours
- Stomach ulcers or any kind of bleeding problems

**Tell your doctor about all your medicines.** Include over-the-counter medicines, vitamins, and herbal products. Tell your doctor if you take or use:

- Medicines called alpha-blockers to treat high blood pressure or prostate problems. Your blood pressure could suddenly get too low. You could get dizzy or faint. Your doctor may start you on a lower dose of VIAGRA.
- Medicines called protease inhibitors for HIV. Your doctor may prescribe a 25 mg dose. Your doctor may limit VIAGRA to 25 mg in a 48-hour period.
- Other methods to cause erections. These include pills, injections, implants, or pumps.
- A medicine called REVATIO. VIAGRA should not be used with REVATIO as REVATIO contains sildenafil, the same medicine found in VIAGRA.

## POSSIBLE SIDE EFFECTS OF VIAGRA

Side effects are mostly mild to moderate. They usually go away after a few hours. Some of these are more likely to happen with higher doses.

**The most common side effects are:**

- Headache
- Feeling flushed
- Upset stomach

**Less common side effects are:**

- Trouble telling blue and green apart or seeing a blue tinge on things
- Eyes being more sensitive to light
- Blurred vision

**Rarely, a small number of men taking VIAGRA have reported these serious events:**

- Having an erection that lasts more than 4 hours. If the erection is not treated right away, long-term loss of potency could occur.
- Sudden decrease or loss of sight in one or both eyes. We do not know if these events are caused by VIAGRA and medicines like it or caused by other factors. They may be caused by conditions like high blood pressure or diabetes. If you have sudden vision changes, stop using VIAGRA and all medicines like it. Call your doctor right away.
- Sudden decrease or loss of hearing. We do not know if these events are caused by VIAGRA and medicines like it or caused by other factors. If you have sudden hearing changes, stop using VIAGRA and all medicines like it. Call your doctor right away.
- Heart attack, stroke, irregular heartbeats, and death. We do not know whether these events are caused by VIAGRA or caused by other factors. Most of these happened in men who already had heart problems.

If you have any of these problems, stop VIAGRA. Call your doctor right away.

## HOW TO TAKE VIAGRA

Do:

- Take VIAGRA only the way your doctor tells you. VIAGRA comes in 25 mg, 50 mg, and 100 mg tablets. Your doctor will tell you how much to take.
- If you are over 65 or have serious liver or kidney problems, your doctor may start you at the lowest dose (25 mg).
- Take VIAGRA about 1 hour before you want to have sex. VIAGRA starts to work in about 30 minutes when you are sexually excited. VIAGRA lasts up to 4 hours.

Don't:

- Do not take VIAGRA more than once a day.
- Do not take more VIAGRA than your doctor tells you. If you think you need more VIAGRA, talk with your doctor.
- Do not start or stop any other medicines before checking with your doctor.

## NEED MORE INFORMATION?

- This is only a summary of important information. Ask your doctor or pharmacist for complete product information OR
- Go to **www.viagra.com or call (888) 4-VIAGRA (484-2472).**

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**DATA-DRIVEN**

**Bratton (second from right) has relied on CompStat, which uses real-time information about crime patterns and demands more accountability from local law-enforcement officers**

LARRY FINK

overcome the incredible skepticism people have toward police and, frankly, toward government."

Bratton has had some experience exporting American-style law enforcement to other countries, and those forays offer glimpses of the potential hazards ahead. After Giuliani fired him in 1996, Bratton eventually opened his own security consulting firm, Bratton Group, that operated out of Kroll's offices. He secured two major contracts with local governments.

### RESISTANCE FROM ABOVE

The first was in the city of Fortaleza, the capital of the state of Ceará in northeastern Brazil. In the late 1990s, the governor, Tasso Jereissati, was worried that the violence, drugs, and organized crime so common in Rio de Janeiro and São Paolo were taking root in Fortaleza. "Our idea was to control it from the beginning," Jereissati recalls. He had read about Bratton and asked him to advise Fortaleza's police. Brazil, like many countries, has military police to maintain order and a civilian force to investigate crimes. "It was difficult to get them to work together and share intelligence," says Jereissati. "Both thought they were losing their autonomy. The old policemen gave a lot of resistance." William Andrews, who had worked as Bratton's special assistant in New York, was involved in these projects. "In Brazil, we did local CompStat continuously, in a very nuts-and-bolts way, creating model precincts," he says.

Term limits forced Jereissati to step down in 2002, and with him went police reform. "We were starting to have good results, but the governor that followed me decided to go with the resistors." Jereissati, who is now a senator, says: "We wanted to train people, not just make a beautiful plan. But it requires big changes to the system."

Bratton was brought to Caracas, Venezuela, in 2000 by a reform-minded mayor, Alfredo Peña, and his police commissioner, Ivan Simonovis, to help set up a new municipal police department. President Hugo Chávez had given more autonomy to Caracas and Peña, an early supporter. Bratton and Andrews knew they couldn't jump in with CompStat across the entire city. "You'd be kidding yourself," says Andrews. "You would be putting on a show, which CompStat can degenerate into. It has to be real, with accurate numbers."

They focused on a district called Catia, an impoverished barrio sprawling up steep slopes in the western part of Caracas. Bratton and Simonovis divided Catia into 12 precincts and found mid-level officers to run them. "The top ranks were very resistant to change," says Andrews. Simonovis arranged for the national police to train Catia's detectives. "There was nothing magical or Sherlock Holmes about it," Andrews continues. "It was just that homicides were being investigated for the first time." Over the next 18 months, Catia's murder rate declined by one-third, he says.

Then Chávez and Peña had a falling out. Graffiti appeared in Catia: "Bratton Go Home." After a brief and unsuccessful coup against Chávez in the spring of 2002, the experiment came to an end. Simonovis was jailed; Peña fled to Miami. "The whole thing fell apart," says Andrews. "Police reform requires constant presence. Institutions revert to form with dazzling speed."

In Chacao, another district of Caracas, the mayor tried to implement CompStat on his own. Leopoldo López came up against a systemic problem of a different kind. He had observed Bratton's work in Catia and knew the drill: He met with his top police officers every Tuesday at 6 am to review crime data. "I was totally committed to changing the way we were policing," he says. "In my district we could do the police management, get accurate measurements." What they didn't have was the support of the attorney general, he says, so "80% of the people we arrested were put back on the streets because of poor process or political reasons."

López, who has been barred from political office, still believes change is possible. "If we had a democracy, we would have been able to implement these reforms in the entire city of Caracas. I have no doubt about that." If ...

Bratton says he understands the ifs, ands, and buts. Political institutions will be fragile; resources scarce. He will have to work neighborhood by neighborhood in these vast metropolises. He will have to adapt to local conditions that he is not even aware of yet. He will have only measured success. "But based on our experiences there is reason to be optimistic. Police can be agents of change," he says. "You have to start with optimism. You have to line up with political leaders who believe you can do good things. Then you have to ask: What is achievable?" | BW |

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# WHAT'S NEXT

## INNOVATION & TECHNOLOGY

# When Body Parts Call the Doctor

Facing saturated markets, cellular carriers are jumping into the remote-health-care revolution



HARRY CAMPBELL

By Kerry Capell

If Telefónica has its way, your knee will one day call your doctor. In partnership with Barcelona's Hospital de la Esperanza, Telefónica has developed a knee brace embedded with motion sensors that enable physicians to monitor patients' rehabilitation remotely after they've been discharged from the hospital. As they exercise, patients—and there are 200 testing the device right now—watch their movements simulated via a 3D avatar on a computer, which wirelessly sends the data to the doctor for view on a PC or cell phone. Telefónica aims to sell the brace to hospitals worldwide when trials are completed by next year.

**$4.4 billion**

**Value of U.S. mobile health market by 2013**

Data: Parks Associates

Until recently, the only connection between cell phones and health was the fear they might cause cancer or traffic accidents. Now, cellular operators are trying to become providers of wireless-health-care products and services. The market, known as mobile or m-health, spans everything from text messaging services to remind people to take medications to implants that monitor heart patients. There are even pills with edible computer chips; the chips send signals to a skin patch, which in turn transmits data to a doctor's cell phone or computer. The information helps doctors track when patients take their medicines and whether there are adverse reactions. "Mobile has the potential to revolutionize the health-care system by increasing efficiency, lowering costs, expanding access to care, and improving patient outcomes," says Alessio Ascari, who leads McKinsey's mobile-health-care initiative from Milan.

Telecom operators view m-health as one of three future revenue streams, along with content and advertising. "All telcos face the same challenge: the commoditization of our core business of voice and broadband," says Alvaro Fernández de Araoz, Telefónica's director of corporate e-health. "We see wireless health care as a major source of new growth."

So does every other major cell-phone player. France Telecom's Orange, AT&T Wireless, Sprint Nextel, Verizon, Vodafone, and Japan's NTT DoCoMo and KDDI all are investing in m-health. Vodafone, the world's largest wireless operator, spotted the potential two years ago when its venture fund took an undisclosed stake in t+Medical, an Oxford University spin-off that uses mobile technology to monitor health conditions. In January, Vodafone opened its own dedicated m-health business unit at its headquarters in Newbury, England, with an initial staff of 45. While Vodafone will not say how much it will invest in the venture, Joaquim Croca, head of Vodafone Health Solutions, says the company is committed to developing the business.

The cell-phone providers are joining a crowded field. Medical equipment giants such as GE Healthcare, Philips, and Siemens, chipmakers such as Intel, and countless startups are developing remote monitoring devices, wearable sensors, and health-related mobile-phone applications as rising costs force



such as diabetes or heart failure, says Donald Casey, CEO of West Wireless Health Institute, a nonprofit medical research group in La Jolla, Calif. "These diseases can be better managed through the use of simple wireless sensors that are inexpensive to manufacture," he adds. Congestive heart failure, the leading cause of hospital admission in the U.S., is an example. Poor control of the disease, the *New England Journal of Medicine* found last year, means that some 27% of patients are readmitted to hospital within 30 days of treatment, costing $10 billion annually. By monitoring patients at home using mobile technology, doctors can spot irregular heart rhythms and adjust treatment, potentially avoiding rehospitalization.

Before the m-health market can take off, however, hospitals, insurers, and doctors need to work out the business model. To persuade insurance companies or government health systems to cover mobile health costs, hospitals and telcos need to collect more clinical evidence showing that m-health can improve care and save money. So far, t+Medical has conducted 20 clinical trials with health-care providers in Britain, the U.S., and Dubai. In one trial, a Bluetooth-enabled glucose meter improved diabetes patients' blood sugar levels and increased the number of patients that could be monitored. "The profession wants to see that mobile technology not only works but that it improves patient outcomes and doesn't increase their workload," says t+Medical founder Lionel Tarassenko.

Telecom providers believe the way to build the business is to team up with medical equipment makers. Orange has inked a deal with Italian medical device company Sorin Group to develop pacemakers and defibrillators that transmit data on a patient's heart rhythms to the doctor without the patient leaving home. Says Thierry Zylberberg, head of Orange's health-care business: "If we can bring efficiency to the system, we will share in that gain with the customer." And if your knee or heart can talk to your doctor, maybe they won't get sent straight to voice mail. |BW|

*-With Mark Scott in London*

a shift in patient care from the hospital to the home. "Wireless companies face a huge challenge because they are up against well-entrenched rivals that have been successfully selling technology in this market for years," says Nicholas McQuire, a research director at IDC in London. The number of wireless health devices is expected to increase from 300,000 in 2009 to 5.2 million by 2014, says consultant ABI Research. In the U.S., the m-health industry is expected to grow from $304 million today to $4.4 billion by 2013, says Dallas technology consultant Parks Associates.

Already a number of specialized products are hitting the international market. France Telecom's Orange and Swedish telco Doro have partnered on a handset for elderly consumers, with big buttons and a larger-than-usual screen. Users can press an emergency button to link to an insurer's call center and request everything from an ambulance to help picking up prescriptions. Telefónica is testing *mi familia*, a service for elderly and Alzheimer's patients and their families in Spain. When customers turn on their cell phone, family members or caregivers can log onto an Internet portal to keep tabs on the person's whereabouts. The phone can be programmed to call the family, ring for medical help, or summon a taxi if needed. "If I ever become disoriented, help is just a button away," says Juan Luis del Arbol Navarro, a 76-year-old customer. "I don't mind if my family follows where I'm going."

An estimated 60% of health-care expenses go toward treating diseases

**WIRELESS COMPANIES FACE ENTRENCHED RIVALS THAT HAVE SOLD MEDICAL EQUIPMENT GLOBALLY FOR YEARS**




INNOVATION & TECHNOLOGY

# Will an AIDS Pill a Day Keep the Virus Away?

Drugmaker Gilead is betting it will—as are some of the world's top health agencies and philanthropists

By Simeon Bennett and Tom Randall

The 30-year war on AIDS has produced its share of notable victories. In the U.S., behavioral changes and combination drug therapies brought down the AIDS-related death toll from a peak of nearly 52,000 in 1994 to about 14,600 in 2007, according to the Centers for Disease Control & Prevention. Yet HIV infections are still spreading rapidly in parts of Africa and Asia. And so far, efforts to find a cure or develop a vaccine that would stop HIV in its tracks have failed.

What if there were another way to slow the pandemic? Gilead Sciences is helping to test a different prevention strategy, which involves dosing individuals at risk of contracting AIDS with drugs normally used to treat people who are already infected. This approach, known as PrEP (pre-exposure prophylaxis), is being tested in 10 clinical trials involving more than 20,000 people in the U.S., Africa, Asia, and Latin America. Gilead has supplied many of the drugs for the trials. Other backers include the CDC, the National Institutes of Health, and the Bill & Melinda Gates Foundation. Researchers expect initial results in July.

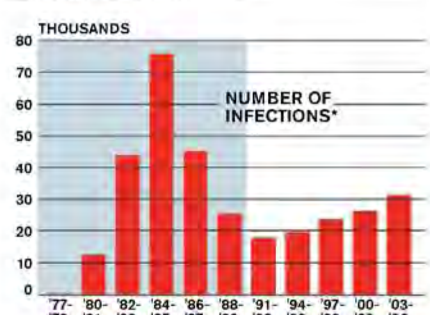
If the data are positive, the approach could have a big impact on the AIDS pandemic—and on Gilead, says Leerink Swann analyst Josh Schimmer. He says PrEP could bring the Foster City (Calif.) company as much as $1 billion in sales in the U.S., where the number of infections among gay men has been rising since 1991, according to the CDC. Gilead pulled in $5.54 billion last year in sales of its top three AIDS drugs—Truvada, Atripla, and Viread—which are taken by 85% of U.S. patients as a first defense against the virus.

In the PrEP trials, Viread or Truvada is administered to uninfected people from groups most at risk of contracting the virus. The studies are also designed to determine whether those receiving the drugs take greater risks in the belief they're protected against the virus. Participants receive counseling on ways to avoid infection.

Speaking to a U.S. Senate committee about global health priorities on Mar. 10, Bill Gates said that, if the trials produce positive results, PrEP distribution programs could begin in developing countries in 2012. "PrEP is the next big thing," says Mitchell Warren, executive director of the New York-based AIDS Vaccine Advocacy Coalition. "We have a level of biological plausibility and early data in animal studies that is stronger than anything we have seen in the other approaches."

## RENEWED THREAT

After falling steeply, new HIV infections are rising again among gay men




*Estimates are an average annual number of infections for a multiyear period

Data: Centers for Disease Control & Prevention

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A study presented last year at the Conference on Retroviruses and Opportunistic Infections (CROI) meeting in Montreal found Truvada cut the risk of infection almost sixteenfold in monkeys.

## THE CASE FOR PrEP

**The acronym stands for pre-exposure prophylaxis, meaning the use of therapeutic drugs to prevent infection. In the absence of an HIV vaccine, here are three reasons PrEP may be the next best thing:**

**1** Early data in animal studies strongly suggest the strategy is effective.

**2** Glaxo's Combivir is already prescribed to prevent infections in men who take it after unprotected sex with an HIV-positive partner.

**3** Some 74% of participants in a 2009 survey of gay men said they would use PrEP if it were available.

There are also precedents for such intervention. Drugs made by GlaxoSmithKline and Boehringer Ingelheim are already used to prevent the virus from passing to babies in the wombs of infected mothers, and Glaxo's Combivir is prescribed to prevent infections in men who take it after unprotected sex with an HIV-positive partner. "I'm very hopeful that this approach will help to reduce HIV infection rates," says Dawn K. Smith, a researcher at the CDC who's devising plans to implement the strategy if it proves effective. "But I want to see the trial results before I call myself a believer."

#### TOO COSTLY?

The world needs new tools to fight AIDS, which is responsible for more deaths than any other infectious disease. About 33 million people live with HIV, according to UNAIDS, the coalition of U.N. agencies formed to fight it. In 2008, 2.7 million people were newly infected with the virus, and 2 million died from AIDS-related complications.

There could be downsides to PrEP. Gilead acknowledges that healthy patients who take AIDS drugs over the long term could experience side effects. And if the promise of protection from HIV appears to spur those at risk to take fewer precautions, the entire PrEP effort could suffer a black eye.

The prognosis for PrEP in sub-Saharan Africa is mixed. Skeptics worry it may be too costly on a continent where 22 million people are infected and per capita income is $951, according to the World Bank. Speaking at this year's CROI in San Francisco in February, Anthony Fauci, director of the U.S. National Institute of Allergy & Infectious Diseases, expressed confidence in PrEP's science but questioned the feasibility. "If we can't get 70% of the people who are infected in low- and middle-income countries on therapy, how are we going to get people who aren't even infected on therapy?" he asked.

In afflicted African countries, finding people best suited for PrEP will be difficult, since nearly everyone who's sexually active is at risk of HIV, says Francois Venter, president of the Southern African HIV Clinicians Society. "I have this horror that we'll have an effective intervention very few people are going to use," Venter says. "I worry that there hasn't been enough focus on who's going to take these drugs."

## ONE POTENTIAL PROBLEM: PrEP COULD SPUR THOSE AT RISK FOR CONTRACTING HIV TO TAKE FEWER PRECAUTIONS




**PrEP proponents: Gates and the AIDS Vaccine Advocacy Coalition's Warren**

Even in wealthy nations cost will be a concern. Giving Truvada to 100,000 at-risk gay men in the U.S. would cost more than $1 billion a year, according to the CDC's Web site. That sum covers only the cost of the pills and doesn't include marketing, HIV testing, and doctors' visits, the agency says.

Assuming PrEP could prevent 50% of infections, it would almost halve the lifetime risk of catching HIV among high-risk gay men in the U.S.—and almost triple the lifetime treatment costs, according to a simulation published in *Clinical Infectious Diseases* in March 2009. PrEP is "unlikely to confer sufficient benefits to justify the current costs" of Truvada in the U.S., researchers from Yale University and Harvard Medical School concluded in the study. The model assumed a drug cost of $753 a month for each patient. The costs of PrEP could be lower if studies show smaller drug doses are equally effective at preventing infections, or if the pills could be taken less frequently, such as shortly before risky sex, instead of every day, said A. David Paltiel, the study's lead author.

Also uncertain is how PrEP might affect business for drugmakers. Gilead's director for clinical affairs, Jim Rooney, says he doesn't know what the commercial implications might be. "It's going to depend upon the data," he says, as well as how health officials evaluate the information and what clinical recommendations they make.

When the first anti-retroviral drugs were approved for treatment in the U.S. in 1987, critics complained they weren't affordable in poor nations, says the CDC's Smith. Now, more than 20 years later, about 40% of those infected worldwide are getting the drugs, according to UNAIDS. Says Smith: "If PrEP is highly efficacious, and if countries and UNAIDS and WHO and other public health agencies believe that it has a role to play in reducing new HIV infections, then we will find a way to make it available." |BW|

(L TO R) PETE MAROVICH/ZUMA PRESS; JULIEN MUGUET/IP3/NEWSCOM




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# A Tear In Japan's Safety Net

## Moves by JAL and Mitsubishi to cut pensions may signal the demise of a trust-based corporate culture

By Jason Clenfield

Workers at Japan's great corporations used to count on two things: a job for life and a decent pension. Lifetime employment in Japan is long gone, picked apart by relentless restructurings. And pensions? A recent series of assaults on big corporate plans raises the possibility that this other pillar of the corporate social contract may be crumbling, too.

The latest implosion of a major pension plan took place at Japan Airlines, which slid into bankruptcy three months ago. On Mar. 18, JAL got permission from the Labor Ministry to slash pension benefits by up to 50% for its 24,000 current and former employees.

Then on Mar. 23, Mitsubishi Heavy Industries said it wanted its workers and retirees to accept cuts that would ease the pressure on its plan, which is underfunded by 259 billion yen ($2.8 billion). Mitsubishi is trying to narrow the pension deficit before new accounting rules take effect in 2012. The new rules will require companies to state in regulatory filings their full unfunded pension liabilities instead of spreading the amount over a longer period.

Since 2002, when the government first allowed companies to cut pensions for retirees, the Labor Ministry has received only six requests to do so. But more companies are expected to try as pension costs mount and the date for the accounting change looms closer. JAL, phone giant NTT, Mitsubishi Heavy, and travel agency Kinki Nippon Tourist publicly have said they want to lower their pension payouts.

Low bond yields, an aging population, and a drop in the stock market to a quarter of its 1989 peak have put a squeeze on Japan's corporate pension funds. Japan's top 278 companies were a combined 21.5 trillion yen ($230 billion) behind on pension funding in fiscal 2009, a 50% increase from the previous year, according to a study by Tokyo's Daiwa Institute of Research. Unfunded liabilities at Hitachi, the country's largest private employer, totaled 1.1 trillion yen ($11.8 billion)—triple the pension deficit that helped sink JAL.

**$230 billion**

**Combined underfunding of pensions at Japan's top 278 companies**

Data: Daiwa Institute of Research

### SCARED BOOMERS

Two-thirds of a company's retirees have to support proposed cuts before a company can seek clearance from regulators to reduce pension benefits. Pressed by their old employers, many retirees vote against their own financial interests. Nobuzaki Yamazaki of the Research Institute for Policies on Pensions & Aging in Tokyo, points out that "retirees feel an emotional connection with people still at the company. The feeling is that 'if current workers can accept a cut, then so can we.'" Other pensioners are angry. "How can you just throw away a contract?" asks Etsuko Hamaya, a 62-year old former JAL flight attendant who retired in 2008 after almost 40 years of service. She stands to lose $650 of her monthly income and voted to keep the plan unchanged.

Defined-benefit programs, which make regular payments to retirees regardless of the ups and downs of the market, remain popular in Japan. According to Stamford (Conn.)-based research firm Greenwich Associates, some 60% of Japan's corporate pension assets are still in defined-benefits plans, which U.S. companies started to phase out decades ago. Many U.S. companies have switched instead to 401(k)-type plans that push the investment risk onto workers.



MAKOTO ISHIDA



Hayashi says NTT bullied pensioners into voting in favor of benefit reductions

Now some Japanese companies also want to lighten their loads. Nippon Telegraph & Telephone, which posted Japan's highest operating profit in fiscal 2008, still has 576 billion yen ($6.2 billion) in unfunded pension liabilities as of last fiscal year. It has been trying for six years to reduce payouts to its retirees. After regulators rejected the telco's petition, NTT pressed on in the courts: The Supreme Court is expected to decide the case this year. In February, Kinki Nippon Tourist, one of Japan's top travel agencies, which lost $8 million in 2009, persuaded its 1,400 retirees to take a 10% cut in their pensions. In March the company got its 2,100 current workers to accept a similar deal.

Economists had hoped Japan's baby boomers would spend their pensions and savings when they retired, weaning Japan off exports as the big source of growth. "Before the baby boomers started to retire there was lots of talk about how they would boost the economy. But that hasn't happened," says Yoshiki Shinke, senior economist at Dai-ichi Life Research Institute. "Instead, people are worried about their pensions, and they don't know how long they're going to live or how much money they'll need. So they're holding on to their funds."

**"HOW CAN YOU JUST THROW AWAY A CONTRACT?" ASKS A RETIREE WHO'S ABOUT TO LOSE $650 A MONTH**

#### "BIG PROBLEMS"

The Japanese see a possible impact on their work culture as well. "What's worse is the simple fact that companies are saying, 'we're not going to keep our promises,'" says Motohiro Morishima, professor of human resource management at Hitotsubashi University in Tokyo. That erosion of trust, Morishima says, could damage the competitiveness of Japanese companies, which tend to rely on shop floor employees to police themselves and refine work processes. "You've got to keep people on the front lines committed or the system is too risky," says Morishima. "There could be big problems."

Taizan Hayashi, a 70-year-old retiree who worked at NTT for four decades, says the company bullied people into voting for the reductions, a charge that many pensioners also levy against JAL. Hayashi persuaded 285 fellow pensioners to sue NTT to stop the plan changes. The lawsuit was thrown out on procedural grounds, but Hayashi is still speaking up. NTT retirees received phone calls and visits to their homes from company representatives. "I got a couple of calls. Other people got more," says Hayashi. "It was like having a bill collector on your back."

NTT spokesman Fumihide Asano says the company didn't pressure retirees unfairly and that retirees accepted the deal because they understood that "difficult business conditions made it necessary." JAL spokeswoman Szu Hunn Yap says JAL's phone calls to retirees simply helped explain the reason for the cuts: "Some of these people have been away from the company for a long time and may have been out of touch with what was happening."

For retired flight attendant Hamaya, a new, more frugal life awaits. "When I was 55, I looked at how much I would get and thought, 'I can make it on this much,'" she says. "My plans have been turned upside down." |BW|

# Can the Masters Tame The Tiger Hunters?

## Augusta National prepares to battle the paparazzi and protect a brand that's about more than money

By John Helyar and Michael Buteau

Fans are not allowed inside the wrought iron gates of Augusta National Golf Club. The sport's most prestigious American venue prefers to call its attendees "patrons." And when those gates swing open on the first day of the Masters tournament, Apr. 8, the patrons won't be holding tickets. Instead, they will be wearing badges, many of them handed down like heirlooms from parent to child. Patrons must check their cell phones and cameras, of course. They are forbidden to run and are expected to meet the standards of decorum set by golf legend Bobby Jones, who co-founded the tournament in 1934. Those standards are still printed each year on the badge's back: "It is appropriate for spectators to applaud successful strokes in proportion to difficulty ... but excess demonstrations ... are not proper. Most distressing to those who love the game of golf is the applauding or cheering of misplays or misfortunes of a player."

Beyond the genteel and exclusive grounds of Augusta National (which, despite protests, still counts no women among its 300 members) is a world where people make a good living off the misplays of the famous. Some of those people are on their way to Augusta National to sneak photos of Tiger Woods as he returns to professional golf. They don't care whether he wins a 15th major championship, but they would love to find a 15th alleged mistress.

For Giles Harrison, a Los Angeles-based paparazzo who shoots for Splash News, the game plan is as follows: Buy a Masters badge on the secondary market (where the Mar. 16 announcement that Woods would play the Masters caused the price on stubhub.com to spike 10%, to about $500). Slip a small camera through security. And compete to get the money shot: "Tiger Woods, a gorgeous woman walking by, his eyes looking in that direction."

Augusta National isn't used to dealing with photographers like Harrison. Its idea of a rogue shooter is the accredited photographer who squeezed off a shot in 2006, just as Phil Mickelson was driving from the 18th tee in the third round. That single click caused Augusta to clear the photo stand for the entire fourth round.

**"HOW DO YOU CONTROL A GOLF TOURNAMENT?" ASKS ONE PLAYER. "HOW DO YOU CONTROL WHAT SOMEBODY MIGHT YELL?"**

The stakes are higher now. Since the Nov. 27 SUV crash that led to revelations of Woods' serial infidelity and the unraveling of his billion-dollar image, paparazzi have camped outside his gated community in Windermere, Fla. A single image, such as the December shot of his wife, Elin, without her wedding ring, can fetch $100,000 from photo services like Splash.

Augusta National, however, is sticking with the official line that this is just another Masters. The club always has a robust force of security agents from Securitas, augmented by officers from the Richmond County (Ga.) Sheriff's Dept. (They came in handy in 2003, when Martha Burk, then chair of the National Council of Women's Organizations, staged a demonstration over Augusta National's refusal to accept women as members.) The tournament doesn't plan to add security, according to a spokesman. The usual plainclothes agents in the gallery will be enough to cart away hecklers or stealth photographers, he says.

Augusta National Chairman Billy Payne knows something about security, having run the 1996 Atlanta Olympics, the scene of a bombing by the American terrorist Eric Robert Rudolph. With luck, Payne's club won't have to contend with anything more lethal than a telephoto lens. "We welcome all visitors," said Augusta Mayor Deke Copenhaver, "but we do expect them to act respectfully."

Colonel Gary Powell of the Richmond County Sheriff's Dept. says the tabloid media haven't been given a designated shooting area outside Augusta National's entry. "They can use public property, and that's it," says Powell. As of Mar. 29 he had received inquiries from only two celebrity-news organizations, the syndicated TV show *Extra* and the Web site TMZ.com. (The latter was already breaking news from Augusta about a Masters-week bikini contest at Hooters that, it predicted, would put "Tiger Woods' newfound willpower ... to the ultimate test.") Other news outlets reported that one of Woods' women friends would spend the Masters week dancing at a men's club up the road in Atlanta.

Augusta thinks it can handle the media crush because it successfully policed singer James Brown's December 2006 funeral. "We don't know what to expect from [the paparazzi]," says Powell, "but we're not worried about them."

In truth, there's an obvious element of unpredictability here—the control freaks of Augusta can't possibly button down all the potential points of disorder. "How do you control a golf





Woods looks for an escape route during the 2009 Masters at Augusta National

tournament?" asks PGA player and Augusta native Charles Howell III. "How do you control what somebody may yell or what somebody may say?"

Even in a worst-case circus scenario, however, with the paparazzi roaming the fairways or chasing Woods down the road to the club, the tournament would suffer no economic damage. That's because Augusta National is a club of wealthy people who aren't in this for the money—and who have never been interested in fully monetizing their brand. The club's membership initiation fee, a reported $25,000, is small change to members like Bill Gates and Warren Buffett. (Liberty National in Jersey City, N.J., in contrast, charged original members $500,000.) Patrons pay $200 for admission to all four rounds, compared with $110 for a single-day U.S. Open ticket at Pebble Beach. The Masters charges $1.50 for sandwiches; $1 for a soda; $2.75 for a domestic beer. "They just want to make enough money so they can continue to reinvest in their product and make it better," says Gary Stevenson, a former PGA Tour executive who heads the consulting division of sports-management firm Wasserman Media Group.

Augusta National doesn't maximize TV revenue by putting broadcast rights out for bid, as major sports properties typically do. The club has signed annual contracts with CBS each year since 1956, trading off greater dollars for greater control. The network is limited to four minutes of commercials an hour and is expected to present the tournament reverentially. (One announcer, Gary McCord, disappeared from broadcasts after declaring in 1994 that Augusta greens were so fast, "I think they bikini-wax them."

In other words, this 66-year-old tournament is more important than money and bigger than any one golfer—even the best there ever was. And if Tiger Woods' brand has been wiped out by a tsunami of scandal, well, Augusta National can't do much about that. What it can and will do is make sure its famous green jackets don't get swept out to sea, as well. |BW|

ANDREW REDINGTON/GETTY IMAGES









**STRATEGY & COMPETITION**

# Night of the Living Dead Brands

Remember Memorex and TDK? So do most consumers, and that's why they live again

By Michael Arndt

You might think a brand is dead when stores stop selling it. Jeff Meredith knows better. The vice-president for global marketing and product development at Imation, the world's largest seller of recordable compact discs, has spent the last couple of years reincarnating Memorex as a line of consumer electronics. Now he's bringing back another relic from the predigital age, TDK, as a high-end line of stereo gear. After that, Meredith wants to rejuvenate at least one other brand: Imation itself. (Remember Imation floppy disks? Remember floppy disks?)

Meredith's work may be make or break for his employer. The 1996 spinoff from 3M has lost money for three years running. Last year's revenue of $1.65 billion was down 20% from the company's peak in 2007 as consumers

LOU BEACH

skip past data-storage media like compact discs and put their data on flash memory, where Imation is only a minor player, or on the Net instead. Charles Murphy, an analyst with Sidoti & Co., says Imation has two years to turn itself around before it could be forced to start burning through its $163 million cash cushion. "It's paramount that they find some way to grow," he says.

Mark Lucas, Imation's chief operating officer, who will move up to CEO in May, says the company is in no danger of running short of money any time soon since it is cash-flow positive. But he says directors want to see better numbers tomorrow. "We're pedaling as fast as we can to demonstrate improvements in our performance," he says.

TDK, Memorex, and other "zombie" brands have an understandable appeal to marketers like Meredith because they come with built-in consumer awareness. That can slash the cost of a marketing launch. Memorex dropped its signature TV ads, with their "Is it live or is it Memorex?" tagline, more than 30 years ago. And yet, Meredith says, research surveys showed that 95% of U.S. consumers knew the name, even among people in their 30s. TDK scored almost as high. "Even though they're defunct, brands still kind of have their own life," says Greg Silverman, global managing director of analytics and valuation at consultancy Interbrand. "The upsides are usually pretty strong."

## THEY'RE BAAACK

**Brands come and go. Some get a second chance.**

**CIRCUIT CITY** The electronics retailer liquidated in early 2009. Systemax bought rights to the name last May to relaunch it as an e-tailer.

**SHARPER IMAGE** A partnership bought the Sharper Image brand in 2008 after the gadget store went bankrupt. The new owners now sell branded foot massagers and such at Best Buy and other chains.

**BRIM** Most people still remember the coffee's TV slogan, "Fill it to the rim—with Brim." Abandoned by Kraft Foods, it was recently revived by River West Brands.




BusinessWeek

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THE NEW
BLOOMBERG
BUSINESSWEEK
APRIL 23

Memorex was a ghost of its former self when Imation bought it in 2006 for $330 million. Sales of blank audio cassettes had been declining since Sony's CD-playing Discman came out in 1991. Imation says recordable CDs and other optical discs seem to have peaked, too: Revenue from those products fell 13% in 2009. As a result, Imation has had to come up with new product categories to refresh the Memorex brand.

The Oakdale (Minn.) company surveyed consumers to find a target audience—that turned out to be mothers 28 to 40 years old who like technology the family can use together—and hired Ziba Design of Portland, Ore., to create electronics for them. Today Imation is selling Memorex-branded iPod accessories, digital photo frames, DVD players, MP3 players, karaoke machines, and TVs at retailers such as Wal-Mart Stores and Target.

The company is extending its rescue efforts. It unveiled a new Memorex collection of Wii accessories at the Consumer Electronics Show in January, and Meredith says it plans to sell speakers, turntables, and other audio gear costing as much as $500 under the label TDK Life on Record in the second half of this year. Imation paid $260 million for TDK in 2007.

The big question for Imation is whether the revivals will work. Sales of the company's electronic gear fell in 2009 but now account for 21% of total revenue, vs. 6.1% in 2006; the electronics unit lost $7 million last year and $13 million in 2008, according to Sidoti's Murphy. He says Imation would be better off finding new data-storage markets rather than pushing deeper into "commodity" gadgetry. "Will consumer electronics make the difference for them?" he asks. "No."

Lucas says Imation is using Memorex and TDK to move into higher-margin products. Soon that will extend to Imation. With sales of magnetic tapes for backup data storage in decline, the company has retained Ziba to find new markets for the Imation brand. Among possibilities: audio/visual products. "The combination of having good solid technology along with a portfolio of brands and a goal of differentiation is going to set us apart," Lucas says. |BW|





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# PERSONAL BUSINESS

MONEY REPORT

## PROGRESSING NICELY



**Shares of Progressive, the fourth-largest U.S. auto insurer, jumped 3.7% on Mar. 26 after FBR Capital Markets raised its rating on the company to outperform and J.P. Morgan raised its rating to neutral from underweight.** It was the stock's biggest one-day gain since Sept. 28. "As many competitors are pushing for rate increases, Progressive is gaining market share while maintaining underwriting margins," wrote FBR analyst Bijan Moazami in a report. As the economy—and car sales—pick up, demand should improve, he figures. Moazami bumped his 12-month price target from 18 to 23; the stock trades around 19.27. He prefers larger insurer Allstate to Progressive, since Allstate's management "faces low-hanging fruit" in areas including homeowners' insurance and Allstate Financial. That said, Moazami thinks that "for investors frustrated with earnings volatility and concerned about catastrophe exposure at Allstate ... Progressive provides an attractive alternative." *-Jamie McGee*

STOCKS

## BUYBACK BOOM?

Stock buybacks are back, rising 37.2% from the third to the fourth quarter of 2009. Since companies presumably wouldn't buy back stock unless they thought it was a bargain, investors usually read more activity as a positive sign. They shouldn't get too excited, suggests Howard Silverblatt of Standard & Poor's, who recently blogged about buybacks for businessweek.com. For all of 2009, there was a 59.5% decline in buybacks from 2008, and a 76.6% decline from 2007. As well, most buyback announcements have been reauthorizations from boards of directors to execute buybacks—a good sign in itself—though the trades have yet to appear. Silverblatt says companies are matching buybacks to the exercising of options by employees, in order to prevent earnings dilution. That's very different from pursuing buybacks to reduce the share count, which would boost earnings per share. "Investors have to decide if the buybacks are actually happening, and if they are, what their use is—prevention of earnings dilution or share count reduction," he says. *-Suzanne Woolley*

**37.2%**

Increase in stock buybacks from the third to the fourth quarter of 2009

Data: Standard & Poor's

JUNK BONDS

## HIGH-YIELD HUNTING

**Junk-bond sales reached a record in March as rising corporate profits and record low Federal Reserve interest rates encouraged lending and investment to low-rated corporate borrowers. Companies worldwide issued at least $39 billion of junk bonds in March, surpassing the earlier high of $36 billion clocked in November 2006, according to data compiled by Bloomberg. Yields fell 0.96 percentage points to within 5.95 percentage points of government debt, the narrowest gap since January 2008, Bank of America Merrill Lynch data show.**

**Yield-hungry fund investors plowed a record $33.6 billion into speculative-grade funds so far this year, according to research firm EPFR Global. Two of Morningstar's highest-rated high-yield taxable bond funds, Pimco High Yield and T. Rowe Price High-Yield, get four stars out of five and take a more conservative stance than many of their peers. They also boast 15-year track records in the top 20% of their fund category.** ***-Bryan Keogh and John Detrixhe***

## INVESTING

EXCHANGE-TRADED FUNDS

# WHY BORING ISN'T BAD

**Exchange-traded funds—baskets of securities that trade like individual stocks—have gained popularity as a low-cost way to track specific indexes, sectors, or commodities from coal to gold.** Since they don't have big marketing costs or portfolios constantly tweaked by managers, fees are low. Now, a new variant, the actively managed ETF—similar to actively managed mutual funds in trying to beat a benchmark but able to be traded throughout the day—is cropping up. Jim Wiandt, publisher of IndexUniverse.com and editor of the *Journal of Indexes*, has followed ETFs since 1999 and advises ETF providers IndexIQ and ETF Securities. Wiandt spoke with reporter Laura Lallos about the funds and other trends.

**A handful of actively managed ETFs have come on the market, and more are in the works. Are those in the pipeline promising?**
There is some great active management out there that is low-expense, intelligently run money. People in taxable accounts will get some extra tax efficiency compared with mutual funds [since the ETFs can prune the lowest cost-basis shares].

You've got PIMCO and T. Rowe Price now, and I could see American Funds coming in. But active management is much more difficult to sell. Up to now, ETFs have largely sold themselves. There was pent-up demand for products like SPDR Gold Shares. As for an S&P 500 index that you could trade in real time, with expenses of only 10 basis points—that sold itself. Active management relies on compensation back to advisers, brokers, and distribution platforms. ETFs are moving in that direction. For example, investors can now buy some ETFs at no cost at Fidelity and Schwab. But there is no such thing as no cost. Investors will likely pay somehow through additional expenses.

**Will we start to see ETFs in 401(k)s, without commissions? If so, will they still have low expenses?**
It would almost have to be that scenario. Investors putting in a few hundred dollars a month would be crushed if they paid a commission each time. And low costs are the pitch in a 401(k), where tax efficiency and the ability to trade real-time are not.

**What is the most significant recent trend in the ETF world?**
Before ETFs, retail investors couldn't get access to commodities at anything approaching a reasonable price. But be aware that most of these invest in futures contracts, not the commodity itself [so won't necessarily track actual commodity prices]. Remember two summers ago, when Lehman imploded and oil prices plunged? Everyone thought oil would go right back up. And it did—but there was no way to bet on it because that expectation was built into the futures market. There's no way for ETFs to invest in oil itself. They would have to store it in tankers off the coast, which would be extremely expensive, and the government probably would never allow it.

Some gold ETFs hold bullion in a vault, so they track the actual price. But these have funky issues too, because they're taxed as collectibles. Even if you hold longer than a year, you will effectively pay income tax of up to 28%.

ETFs have gotten this sexy brand name, but the best are broadly diversified with rock-bottom costs. Exciting and investing should not go together. |BW|

### LOW-COST LEADERS

ETFs offer the cheapest index funds, as well as affordable access to commodities. You can dollar-cost average or reinvest dividends with no commission if you buy iShares at Fidelity or Schwab's ETFs at Schwab.

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| Schwab U.S. Broad Market ETF/SCHB | 0.08% |
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| iShares Barclays TIPS Bond/TIP | 0.20 |
| Vanguard FTSE All-World ex-US ETF/VEU | 0.25 |
| Vanguard Energy ETF/VDE | 0.25 |
| SPDR Gold Shares/GLD | 0.40 |

Data: Morningstar

## INVESTING

BONDS

# A BOND KING TURNS BEAR

By Tom Keene and Susanne Walker

**The almost three-decade bond market rally may be drawing to a close, says Bill Gross, manager of the $214 billion Pimco Total Return Fund, the world's largest bond fund.** "Bonds have seen their best days," Gross told Bloomberg Radio in a Mar. 25 interview. "Real [inflation-adjusted] interest rates are moving higher." Yields on two-year U.S. Treasury notes are likely to rise from 1.08% to 1.25%-1.5% in the next year as the economy strengthens and the Federal Reserve begins to raise interest rates, he says. When rates go up, bond prices go down, and that means a bearish market for bondholders. Pimco Total Return had a 16% gain in the past year, beating 54% of its peers, according to data compiled by Bloomberg.

Under what Pimco calls the "new normal," investors should expect lower-than-average historical returns with heightened government regulation, lower consumption, slower growth, and a shrinking global role for the U.S. economy. Huge borrowing in nations including the U.S., U.K., and Japan will eventually lead to inflation as governments sell record amounts of debt to finance surging deficits, Gross predicts.

### LOOK TO GERMANY, CANADA

Pimco, which announced in December it would offer stock funds for the first time, is advising investors to buy the debt of countries such as Germany and Canada that have low deficits and higher-yielding corporate securities. In a recent investor commentary, Gross recommended avoiding U.K. debt and buying shorter-maturity U.S. and Brazilian government bonds, as well as longer-maturity German and "core" Europe bonds.

Gross increased holdings of bonds from non-U.S. developed nations in his Total Return Fund for a fourth straight month in February, taking them to the highest level since May 2004, according to data on the company's Web site. He increased government-related debt to 35% from 31%, the first rise since October 2009, and lowered net cash to 2% from 9%. U.S. Treasuries have returned 0.9% this year, compared with 2.7% for German government bonds and 0.5% for U.K. gilts, according to indexes compiled by Bank of America Merrill Lynch.

### EMERGING OPPORTUNITIES

Gross's global focus extends beyond bonds. The No. 1 thing Americans should do to try to make back wealth is to "move outside of the United States" in choosing stocks, he says. Many companies in the S&P 500 do have global businesses, he notes, but the focus should be on emerging and developing countries because they are now "creditor countries" that feature strong growth. Developed countries are now the "debtor countries" and face weaker growth. "What an investor wants to do, either from a standpoint of stocks or bonds, is go to countries with high real [inflation-adjusted] interest rates," says Gross. The "typical suspects" to invest in include Brazil, China, and India, he adds. There is a caveat to emerging-market investments, says Gross. Emerging countries can have problems in terms of asset bubbles and property rights.



Pimco filed with regulators last December to start a stock fund that can invest in bank loans, junk bonds, and distressed securities. The Pimco Global Opportunities Fund will buy securities and financial instruments "economically tied" to at least three countries, one of which may be the U.S., according to a company filing.

Whatever approach investors take with their bonds, Gross suggests a wise motto to adopt in his latest investor commentary: When evaluating sovereign debt, "Don't trust any government and verify before you invest." BW

DREW FRIEDMAN

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# BUSINESS VIEWS

**EDUCATION**

**By LOUIS LAVELLE AND GEOFF GLOECKLER**

# B-Schools: Help Wanted

## With management education under assault, the three top schools are getting new leaders




ROSS McDONALD

In the next few months there'll be a rare confluence of change at the pinnacle of management education. The two top business schools in *Bloomberg BusinessWeek*'s biennial ranking of full-time MBA programs—the University of Chicago Booth School of Business and Harvard Business School—will lose their deans to a rival and retirement, respectively. Their replacements,

# EDUCATION

as yet unknown, will have a huge role in determining how thousands of future business leaders get educated. That is, if they get educated.

This changing of the guard comes at a moment when the utility of a business school education increasingly is being called into question. The financial crisis has made it difficult for graduates from even top schools to find jobs. At No. 1-ranked Chicago, 13.5% of 2009 graduates were jobless three months after graduation, a more than fivefold increase over 2007. Endowments, having sustained their worst losses since the Great Depression, are so battered that even storied Harvard has been forced to lay off 16 HBS staffers. And with so many alums working on Wall Street, top B-schools are under attack from critics who blame the financial meltdown on MBAs—an acronym that author Philip Delves Broughton considers shorthand for "Masters of the Business Apocalypse."

It's this transformed world that the new leaders at Chicago and Harvard are expected to inherit this summer. One institution, No. 3-ranked Northwestern University Kellogg School of Management, has already taken the first steps. On Tuesday, it announced that Sally Blount of New York University's Stern School of Business will replace interim dean Sunil Chopra, assuming the position vacated by Dipak Jain.

The choice speaks volumes about where Kellogg sees its future. At NYU, where Blount is dean of the undergraduate college and vice-dean at Stern, she is known as a skilled fund-raiser and a curriculum innovator with a global bent. Under her guidance, NYU started two new global degree options that require students to spend several semesters abroad. "The fundamentals haven't changed," Blount says of the challenges she will face at Kellogg. "The bigger changes are more global, and making sure that people know how to be 'boundary-spanners'—across geographies, ethnicities, and disciplines."

Deans at top B-schools are expected to be fund-raisers, construction foremen, consensus builders, talent poachers, publicists, foreign emissaries, and visionaries-in-chief. It's not an easy gig to fill in the best of times, especially for the top three schools, whose leaders are under a microscope. "They're very influential over the rest of the 12,000 business schools in the world," says John J. Fernandes, CEO of AACSB International, which accredits B-schools worldwide. "It's like being appointed head of a G7 country."




## MBAs ARE SCORNED AS "MASTERS OF THE BUSINESS APOCALYPSE," RESPONSIBLE FOR THE MELTDOWN

Business schools may need fresh blood to tackle the problems they face, but new deans are almost always academic lifers, not corporate kingpins. One reason, says Glen Urban, dean emeritus at the Massachusetts Institute of Technology Sloan School of Management, is that even top schools can't afford the best corporate talent. And such "nontraditional" candidates often simply aren't equipped to deal with tenured faculty, who frequently are resistant to change. "There's always the analogy of herding cats around a baseball diamond in the rain," Urban says. "You might think you're in control more than you actually are."

At Chicago, outgoing Dean Edward Snyder was particularly adept at fund-raising: He scored the biggest B-school gift ever, a $300 million whopper from alumnus David Booth. He also expanded Booth's international footprint and retained its roster of star faculty, including several Nobel Prize winners. Still, the school got hammered by the economy last year, with its job placement rate at graduation falling 16 percentage points, to 79%; its endowment posted a 23% loss, to $389 million.

Those mentioned as possible successors—according to alumni, faculty, and student leaders—include two Booth deputy deans, Mark E. Zmijewski and Stacey Kole, and Associate Professor Hasell H. McClellan of Boston College's Carroll School of Management. Zmijewski says he's not a candidate, Kole declined to comment, and McClellan, reached by telephone, said he has not been contacted by anyone from the search committee. "This is the first I heard of it," he says.

Harvard, being Harvard, is taking a big-picture approach to its dean search. At the HBS 2008 centennial, outgoing Dean Jay O. Light spoke about the importance of experiential learning and keeping the curriculum relevant and focused on leadership skills. His remarks were a road map of the challenges his successor, and all B-school deans, soon will face. The names that have surfaced in connection with the search are all Harvard insiders. Joseph L. Badaracco is a senior associate dean and chair of the MBA program, Nitin Nohria is a business professor, and Srikant M. Datar is a senior associate dean. Badaracco and Nohria declined to comment; Datar did not return calls.

Whoever it is, says HBS Alumni Board President Ann Kelly, the new dean should have strong leadership skills and a deep understanding of HBS. "We want someone who can be visionary, but not so visionary that you undo all of the good things that have been done in the past," Kelly says. Maybe so, but with their collective past under attack, B-schools might want to consider a radical idea: a clean break. |BW|

ROSS MCDONALD

# BOOKS

By ARIK HESSELDAHL

# The Power And the Glory

## The humble battery has a colorful family history, and portable power cells have played a pivotal role in the evolution of technology

You've met it many times, but it's a good bet that you know next to nothing of the life story of the tech world's Rodney Dangerfield. Instead, you dote on the latest handheld device or flashy new car, neither of which could function without the humble battery, the device-within-a-device that has underpinned an enormous slice of high tech's progress.

Author Henry Schlesinger, a science journalist who has written extensively for *Popular Science* and *Smithsonian*, became a battery nut while researching a previous book on espionage, a field in which life and death ride on nickel and cadmium more often than you might think. In *The Battery: How Portable Power Sparked a Technological Revolution*, Schlesinger serves as a guide on a bus tour through not only the developmental history of the battery but through the lore of many other things electrical. The journey begins in the 1740s with the birth of an early proto-battery known as a Leyden jar, named for the city in the Netherlands where it was first developed. Essentially, Leydens were metal-lined glass vessels used to store static electricity. They delivered a powerful and painful shock to anyone who touched them. Ben Franklin didn't discover electricity, but he did use a Leyden jar, attached to a kite, when he set out to prove the electrical nature of lightning.

The first battery to produce a reliable, steady charge arrived in 1800 from the work of the Italian professor Allessandro Volta, whose name was later given to the unit of electrical potential, the volt. His voltaic pile was a stack of 40 pieces each of zinc and silver separated by pieces of thick paper soaked in water. Being cylindrical, it looks vaguely like a battery but more like a French coffee press. (The book has a number of helpful hand-drawn illustrations.) Its most notable use was in macabre, widely seen stage shows where electrical charges were used to contort the faces of freshly decapitated prisoners. The author theorizes that these spectacles inspired Mary Shelley when she wrote *Frankenstein*.

Despite his many tangents, Schlesinger is most interested in the battery's influence on technological progress, not literature. Samuel Morse, for instance, needed batteries to invent the telegraph. We can also thank batteries for the stock ticker, the transistor radio, the cathode ray tube, and the Hubble telescope. Oddly enough, the battery was no friend of Thomas Edison. In the race to build a horseless carriage, he failed to perfect a battery-powered automobile as his former employee, Henry Ford, came up with the Model T. Another Edison failure, depending on how you look at it, was a battery-powered vibrating pen for making copies of handwritten documents; it was later adopted by tattoo artists.

Many fortunes were made and lost on batteries. When he died at age 71 in the late 1920s, Russian immigrant Conrad Hubert was worth $6 million, thanks to his American Ever-Ready Co., which commercialized the flashlight. In 1947, Joshua Lionel Cowen claimed he had given Hubert the bright idea, though he wasn't bitter; he made his own fortune selling toy electric trains under the brand name Lionel.

Hubert's company eventually became Eveready, now part of the $4 billion battery concern Energizer Holdings. Shipping heir Phillip Rogers Mallory left the family business and teamed up with inventor Samuel Ruben in 1925, and their company eventually became Duracell, now part of Procter & Gamble. Before starting Motorola in the late 1920s, Paul Galvin started a battery company that failed to take off.

Despite Schlesinger's emphasis on the science, he manages to keep the book surprisingly lively. The story of portable power, in his telling, takes us in all kinds of entertaining directions. If *The Battery* has a serious shortcoming, it's Schlesinger's cursory treatment of recent years. Just as the rechargeable era dawns, he runs out of juice. The pivotal 1990s, as lithium-ion batteries came to dominate the digital landscape, are dealt with in one page. Asian electronics companies trounced their rivals and are on "the verge of some very large technological advances." Some readers would be willing to trade a few details on Leyden jars for something that hits closer to home. |BW|




***The Battery: How Portable Power Sparked a Technological Revolution* by Henry Schlesinger; Smithsonian Books; $25.99; 287 pp**

# FEEDBACK

## CHINA

### CORPORATE AMERICA'S UNHOLY ALLIANCE

Regarding "Closing for Business?" (In Depth, Apr. 5): What did Corporate America expect when they got into bed with China, heaven? They are getting what they deserve—the shaft.

All one needs to do is look at the history of China and any other totalitarian country. They screw their own people, so why wouldn't they screw outsiders? They have taken advantage of our own greed for profits and lured us in with cheap costs. Our great corporations, starting with Wal-Mart, really thought they had the Communist Chinese government snookered. Well, boys, they've got you where they want you.

I for one have tried not to buy anything made in China. Nothing sold at Wal-Mart. They are complicit with what China is trying to do—bring us to our knees and ruin our society.

Wake up, Corporate America. You are contributing to the demise of the United States of America.

**Jeff OKon**
**The Jaczen Group**
WEST PALM BEACH, FLA.

## HEALTH CARE

### WHERE OBAMACARE FALLS SHORT

For all the things Obamacare proposes to do, it ignores the basic problem with health care: the impact that individual choice and responsibility have on cost and quality of service ("Obamacare's Cost Scalpel," What's Next, Apr. 5). The problem has always been that the individual was not in control or responsible for payment of health-care services; insurance providers and government (Medicare and Medicaid) negotiate prices and pay the bills. With Obamacare, the individual is moved further away from the responsibility for health-care costs and services. Without free-market choices by the individual, we will only see a continued increase in costs and government rationing of health-care services.

**Linden R. Welsch**
**Welsch & Ward, CPAs**
AUSTIN, TEX.




Poor John Boehner! So bitterly you wept as you bemoaned the Democrats ramming health care through Congress, and so pitifully you sob that they've violated the will of the people! But you see, John, I have an attention span, so I remember when both Congress and the entire Bush Administration were doing both of those every minute, and you were loving it! Typical Republican hypocrisy...

**J. Andrew Smith**
BLOOMFIELD, N.J.

Why should I put my faith in [Budget Director] Peter Orszag's approach to reducing health-care costs when he has shown no ability to improve our economy, which is his expertise? I visit my physician for medical consultation, not my CPA.

**Chuck Vogeler**
WAILEA, HAWAII

Damien Proctor's assertion of the need for reform based on his reaction to "Lessons of a $618,616 Death" (Feedback, Business Views, Apr. 5) is typical of many Obamacare supporters. I wonder what he would propose that would change the outcome of the story. I suspect he has no idea. We were all touched. That doesn't change anything.

**Rick Cunnington**
ORO VALLEY, ARIZ.

## CLIMATE CHANGE

### GLOBAL WARMING: A LOT OF HOT AIR?

It's certainly news to me that climate change, which has been the case for millennia, is becoming more urgent by the month ("Engineering the Earth," Books, Apr. 5). The last I heard and saw was that the globe has been cooling for the past 10-11 years, and warming and cooling periods have occurred over long stretches. Without definitive data, why would anyone deliberately want to cool off the planet? After all, global cooling was the urgent problem some 30 years ago.

**Philip Melita, PhD**
CHARLOTTESVILLE, VA.

*Book review author Eric Roston replies: The decade Mr. Melita refers to as a cooling period is in fact the hottest in recorded history.*

**CORRECTIONS & CLARIFICATIONS**

"Stuck with Sears" (In Depth, Apr. 5) was in error when it said that Edward Lampert had sold 4.6 million shares of his stake in Sears Holdings. A Lampert spokesman says the shares were distributed from Lampert's RBS Partners fund to various partners, including Lampert himself.

"The Last Picture Show at Blockbuster?" (New Business, Apr. 5) gave the wrong title for Sony Pictures Entertainment Chairman Michael Lynton.

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# OUTSIDE SHOT

By RAGHURAM RAJAN

# An Army of Unpaid Regulators

## Bank debt holders came through the crisis unscathed. Tweaking the Dodd bill would make them soldiers in the war on foolish risk

The Dodd financial reform bill, which awaits the Senate after its two-week break, is loaded with good intentions. But does it do enough to keep banks from going out on a limb for profits?

The type of risks that put banks in the greatest jeopardy—and led to the recent crisis—are called tail risks. They have a small probability of turning out badly but are extremely costly if they do. Banks took on two kinds of tail risks prior to the crisis. One was economy-wide default risk, the risk that a broad portfolio of assets, such as mortgages, would suffer deep losses. The other was liquidity risk, essentially the way they financed the first kind of risk.

Some banks—such as Citibank, Lehman Brothers, and Royal Bank of Scotland—loaded up on both risks, holding enormous quantities of mortgage-backed securities on the asset side and paying for them with short maturity debt on the liability side. Why did they do it? The simple answer: It was very profitable, provided the tail events did not materialize. Think of insurers that write a lot of earthquake policies (another tail risk). If you didn't know they were writing earthquake insurance and not setting aside reserves, you would think they were enormously profitable until there's a quake. For banks, there was always the threat of a day of reckoning when liquidity dried up and defaults skyrocketed. But they set aside few reserves against that happening.

Some commentators, looking at the enormous stockholdings that CEOs such as Dick Fuld of Lehman had in their own firms, argue that perverse risk-taking had nothing to do with incentives. They miss the point that anyone who has an equity-like claim to all the upside of a firm's profits (and faces a fraction of the leveraged losses) has an incentive to take on tail risk because there are fat premiums for doing so. And if the tail risk does not hit for a long time, CEOs who are rewarded with stock and stock options can end up with enormous holdings. In fact, studies show that CEOs of banks that paid most aggressively took the greatest risks. It paid off during the 1990s, creating once-heroic CEOs like Jimmy Cayne of Bear Stearns and Lehman's Fuld. The Fed came to their rescue, both in the turmoil of 1998 and after the dot-com bust in 2001. But the panic of 2007-08 was an order of magnitude larger.

Particularly worrisome, as my colleague Douglas Diamond and I have argued, is that once banks are leveraged enough that they will be severely distressed if economywide liquidity dries up, they double down on risky bets. This appears to be what a number of banks did as the crisis loomed. Stockholders and boards are in the same position as the CEO when a bank is thinly capitalized and have little reason to curb risk-taking. This is why proposals to increase capital requirements are critical; they give equity holders something to lose.

What about the debt holders? Theoretically, they bear the bulk of downside risk. The intervention by the government and the Fed in 2008, however, confirmed their belief that they'll be bailed out when a panic arises. This banishes their fears about bank risk-taking. But there's a way to line up their self-interest with regulators' presumed goal of protecting the economy from the adverse effects of tail risks.



Here's the drill: To make it harder for tail-risk-taking banks to grow, all banks should be required to issue a minimum level of debt (say, 10% of assets) that is automatically impaired—either converted to equity or written down—if the bank suffers sufficient losses. This will quickly change debt holders' views on risky expansion. Moreover, no financial institution should be allowed to hold this debt. This will lessen the need for bailouts to avoid contagion. It also makes sense to phase out deposit insurance as a bank's deposits hit a certain level so that the government doesn't subsidize size (or risk-taking). By strengthening proposals to bring debt holders into the equation, the Dodd bill will add up to a much more powerful corrective. | BW |

*Raghuram Rajan is professor of finance at the University of Chicago's Booth School and author of the forthcoming book* Fault Lines. *He was the IMF's chief economist from 2003 to 2007.*

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